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PROBLEMS OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC]

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

THE PROBLEMS IN THE SAVINGS AND LOAN INDUSTRY AND THE POTENTIAL THREAT TO THE INSURANCE FUND PROTECTING S&L DEPOSITS

PART II OF IV

FEBRUARY 22, 23, 28, MARCH 1, AND 2, 1989

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PROBLEMS OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC]

PART II OF IV

WEDNESDAY, FEBRUARY 22, 1989

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10:05 a.m. in room SD-106, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Sarbanes, Dixon, Sanford, Graham, Wirth, Bryan, Garn, Heinz, D'Amato, Gramm, Bond, Mack, Kassebaum, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The Chairman. The committee will come to order.

Let me invite all of those in the room to try to find a seat if they can, so we can keep the noise in the room to a minimum in the course of the hearing this morning.

We have come to this larger room because there was a very substantial interest, both by the press and the public that want to be present today as Secretary Brady presents the administration's plan to deal with the problems of the savings and loan and the insurance fund behind the savings and loan system.

So we are in a different setting than is normally the case and, because it is a bigger room, I am going to ask that all the members as they make their opening comments and address questions speak loudly so the Secretary and others in the room can hear and the same when the Secretary responds to questions as the morning goes along.

We have, of course, today as we begin this hearing a series of other hearings taking place, other important matters before the Senate, the Tower nomination in the Armed Services Committee. There is a very important hearing taking place in the Energy Committee on the problem of nuclear waste cleanup at processing plants, and a number of our colleagues are also required to be in other committees at precisely this hour.

It is the nature and circumstance here that that often happens. So members will be coming and going during the course of the morning to meet those multiple responsibilities.

I want to hold up a copy of the bill that the administration has brought and presented to me and Senator Garn this morning. I gather it is hot off the press. Let me just see how many pages we have. A 333-page bill. So in a sense it helps illustrate the complexity of the problem of trying to reduce to formal legislative language a proposal for solving the savings and loan problem obviously requires this kind of detailed legislative action in order to accomplish that goal.

Senator Garn and I have indicated that we are prepared to introduce that legislative package today by request, and we will do so.

Of course, now that we have the formal document with all the fine print, we will be able to work on it in a more complete way, and that work will commence immediately.

Today begins the fifth committee hearing, and I think the most important one of all, on the problems facing the Federal Savings & Loan Insurance Corporation and the savings and loan system.

The Treasury Secretary is here today to formally present the administration's proposal and to explain it to us in detail. I think Treasury Secretary Brady and President Bush are to be commended for directly facing the problem for developing a comprehensive proposal quickly, and we very much appreciate the Secretary's appearance here this morning.

During the next 5 days the committee will give the administration and the bank regulators an opportunity to explain all aspects of this proposal. We look forward, for example, tomorrow to hearing from Federal Reserve Chairman Greenspan on this subject. He will be followed on subsequent days by FDIC Chairman Seidman, by Comptroller of the Currency Clarke, by Federal Home Loan Bank Board Chairman Wall, and OMB Director Darman.

The committee will then hear from a variety of other interested parties. I intend to complete these hearings by March 17.

From March 20 to April 2, which is the Easter recess, the committee and its staff will be at work together with the administration to develop the final legislative package. I believe that package will earn the strong support of the committee and of the Senate.

President Bush has said directly that he expects some adjustments and modifications to this plan, and properly there will need to be some made, but we will work with the administration as we go through the process of making those adjustments.

Now, the thrift industry's problems are extremely serious. They have generated enormous public and press attention, and for good reason. But one point is not in question, and that is the absolute safety of federally insured deposits.

As Senator Garn and I have repeatedly made clear, the full faith and credit of the U.S. Government stands behind every dollar of deposits at federally insured savings and loan institutions up to the $100,000 insurance limit for each deposit.

So people's deposits are safe. They need not worry. That is an ironclad guarantee.

President Bush has also on numerous occasions made this absolutely clear.

With respect to the proposal itself, we are just today, as I indicated earlier, receiving the precise legislative language, and so we will now begin the review of that, but in terms of the general outline of the proposal which we have had prior to today, I think there is much to be said for the proposal.

It wisely suggests separating the Federal Savings and Loan Insurance Corporation from the Federal Home Loan Bank Board and breaking up the historically close relationship between the thrift industry and its regulators.

It calls for capital and accounting standards to be strengthened, and they need to be. The Government must crack down and put in jail the white collar criminals who have abused their positions of trust and also recover as much money as possible.

The committee clearly supports these and other key aspects of the President's proposal, but there are some other very important issues that remain to be more adequately addressed. Here is a partial list.

Is the financing mechanism proposed by the administration sound?

Does it provide enough money, and is it the least expensive alternative from the taxpayers' point of view?

What activities, if any, should be prohibited for a State-chartered institution which enjoys Federal deposit insurance?

What should be the criteria for making such a decision?

I believe that Federal deposit insurance should only cover Federally authorized activities. This has been a root cause of the financial disaster now facing the S&L industry.

Another question, do we need a separate thrift industry to do housing finance in the future and, if so, what should a thrift operating charter in the future look like?

If we are going to give special advantages to a specialized institution, we clearly and precisely have to define the activities that that institution may engage in.

I would say that the Treasury proposal in large part does not yet answer that question.

These are a few of the issues that we will have to work on together to resolve. I believe that we will be able to do so, and I look forward to working with all the members of the committee and with our witnesses to move this legislation promptly.

And let me just finally say before yielding to Senator Garn that I think we have established a very good working relationship with you, Secretary Brady, and with your people at the Treasury Department. You have been available, you have been cooperative, and I think we have developed a good, strong, reciprocal relationship that I think will take us on through a sound solution to this problem and others that may come later. I trust that you will have found and will continue to find that this committee will act in the same manner with the Treasury Department and the administration.

This problem has got to be solved. We can and we will put a solution in place, and it will be one that will provide a strong and a lasting answer.

With that, let me yield to Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you very much, Mr. Chairman.

First of all, let me thank you for the speed with which you have put the hearings together and your cooperation with me on a bipartisan basis on a very difficult problem.

Secretary Brady, I am happy to welcome you back before the Banking Committee. It seems to me you certainly went to a great deal of trouble as a former member of this committee to be able to testify before us. If you had stayed as a Member of the Senate, we would have allowed you to speak even though you would have been a junior member of the committee, but we are very pleased to have you with us today.

Let me begin by applauding the administration for stepping right up to the plate with a bold, comprehensive plan to address what we all know is a very ugly problem. Your proposed fundamental reforms would turn to the taxpayer only as a last resort. You have already started taking steps even before the legislation is enacted. All three steps, in my opinion, are absolutely critical.

I recognize that critics have already begun lining up to take shots at different aspects of the plan. That is inevitable. I, myself, am not happy with every detail that I have seen.

The Congress will no doubt make some changes as the legislative process moves forward. I believe these are disputes, however, that are at the margin. The administration's plan credibly addresses the most important issues, and I believe that has been recognized by most.

It is more than a first step in the process. It is the basic model that Congress will use to solve this problem.

That is why I will do everything I can with the chairman to meet the President's request for legislation in 45 days, at least in this committee. It is a tall order, but I believe it is possible to be done for three reasons.

First, as I have already said, the administration has put a Federal plan on the table that we can work with and use as a foundation for a solution. We won't have to waste a lot of time trying to come up with a plan of our own.

Second, I believe there is a truly bipartisan consensus that can be reached using the administration plan as a foundation. There will be debate, as there should be, but I have every reason to think that we can avoid partisan bickering.

Finally, and most importantly, we simply cannot afford to wait. The problem will continue to hemorrhage every day that we delay infusing cash into the insurance funds.

The public is anxious. The healthy part of the industry needs relief. Congress has already caused enough problems through delay. We need to move as quickly on this plan as we possibly can, and I urge all of my colleagues in both the House and the Senate to do that.

With that, let me do my own part in speeding up the process by not saying anything else.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

I want to underscore your point about the bipartisan approach and cooperation. I think you and I have had an excellent relationship over the years and we do today. I think it extends down both sides of the committee table, and we are determined to work as a unit, as a committee, to produce this legislation.

With that, Senator Sarbanes.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman.

I join with you and Senator Garn in welcoming the Secretary here this morning to present the official administration proposal on dealing with the savings and loan crisis.

I note with interest that the bill has now been submitted, I take it this morning, and we are very pleased now to have the administration's thinking on this issue actually encapsulated in legislative language.

Mr. Chairman, I particularly want to commend you for moving so expeditiously to organize an extensive and thorough series of hearings on the entire S&L issue. In fact, you moved ahead of the administration's submittal even of its proposal, let alone of legislation, in order to bring the committee to grips with this issue, and I join with others in anticipating expeditious action in this committee on this matter, and I hope that we will have legislation on the floor of the Senate in fairly short order.

I think it is very important—and I take it this has been the Treasury's approach—not merely to seek to recover from a dangerous situation, but in fact to set things right for the future, and I would be interested as we carefully examine the Treasury's submission in the days to come whether or not this is in fact the case.

I think it is very important that as we address this crisis we do it in such a way as to ensure that we will not be confronted with another one in the near or middle or even distant future, so that we are really coming to grips with some of the structural or systematic problems that have led to this situation.

I understand that is the approach the Secretary has taken, and if that in fact is what is encompassed in this legislation, I very strongly commend Treasury Secretary Brady for coming forward with such a proposal.

I am looking forward to hearing the Secretary's statement this morning.

Thank you.

The CHAIRMAN. Thank you, Senator Sarbanes. I appreciate your personal comments.

Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I want to join you in welcoming Secretary Brady

I reflect on when President Bush first revealed his plan to resolve the S&L crisis. I called it the closest thing to a swan in a pond full of ugly ducklings. I also said that President Bush deserved a great deal of credit because he didn't duck this important issue.

Today this committee will have an opportunity to determine whether the administration's plan is all it is quacked up to be. [Laughter.]

This committee is very adept at taking shots. We have taken shots at an anonymous plan to tax savings. We have taken shots, Senator Bond in particular, at the S&L kingpins.

So it will come as no surprise to you that open season has been declared on this plan. Members of the bank and thrift industries are standing ready to take aim at several aspects of this proposed legislation. In fact, they have already taken some pot shots at the plan and hope to shoot it full of holes. No doubt several members of this committee hope to have the ammunition to modify parts of the plan.

But since this proposal does indeed encompass a comprehensive resolution of the S&L crisis, it now becomes the latest target.

Now, while I reserve my right to bear arms along with all my colleagues and everybody else, I do believe that your proposal and President Bush's proposal deserves more than just a sporting chance to get off the ground. Clearly, any solution to this problem that emerges is going to be a creature of the legislative process. When Congress is finished, the plan may not be a swan or a duck, but I can assure you personally, Nick, that my goal is to put together the best possible solution and to make sure that it will fly.

I want to make one other observation about something Senator Garn said about this plan; namely, that taxpayer dollars were used by the Treasury only as a last resort. With a minimum of $40 billion of taxpayer money included in this plan, this plan checks into the biggest resort in history, and there are going to be a lot of people who would like to minimize that.

I am one of them, but I suspect we are not going to be able to minimize it a lot.

There are other people who are going to say that there are too many reforms in your legislation aimed at overkill, making sure this situation never happens again.

My view is that if the taxpayers are going to have to stand up and shell out $40 billion they are entitled to all the reform they want.

Thank you.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Dixon.

OPENING REMARKS OF SENATOR DIXON

Senator DIXON. Thank you, Mr. Chairman.

Mr. Secretary, I am pleased to see you here again this morning. As you know, last month on the Senate floor, Mr. Secretary, I set out a series of basic principles that I believe any legislative solution must meet.

I said then that no plan could succeed unless it provides the kind of financial assistance and regulatory reform that assures that we will never be faced with this problem again, that it is clearly large enough to solve the problem, that it resolves the thrift industry problem without creating any new problems, that it punishes those who through either negligence or even fraud helped to bring so many of our Nation's thrifts into insolvency, and that it minimizes the taxpayers' role in this process while maximizing the contribution from the thrift industry itself.

I want to say, Mr. Secretary, I believe the administration's plan does address those basic principles. I, of course, reserve the right to participate in this committee in making whatever changes we ultimately determine are necessary to pass this legislation in this session of the Congress, but I want to take this opportunity to congratulate you, Mr. Secretary, and those in the administration for your obvious willingness to enter into an accommodation with us in the Congress and to see to it that meaningful legislation is expeditiously passed, and I assure you that this member of the committee will do all he can to achieve that result at a very near, short date.

Mr. Chairman, I ask that the balance of my remarks be fully reproduced in the record as though read.

The **Chairman**. Without objection, so ordered.

[The complete prepared statement of Senator Dixon follows:]

STATEMENT OF SENATOR ALAN DIXON

Senator **Dixon**. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee continues its series of hearings into the crisis facing the savings and loan industry and its insurance fund. I look forward to hearing the testimony of the distinguished Secretary of the Treasury, Nicholas Brady, a former member of this committee.

At the outset, I want to commend Secretary Brady for his leadership role in designing the administration's recapitalization and regulatory reform proposal. It is a solid proposal, with many elements that I strongly support.

Last month on the Senate floor, I set out a series of basic principles that I believe any legislative solution must meet. I said then that no plan could succeed unless: it provides the kind of financial assistance and regulatory reform: that insures we will never be faced with this problem again; it is clearly large enough to solve the problem; it resolved the thirft industry problem without creating any new problems; it punishes those, who through either negligence or even fraud, helped bring so many of our Nation's thrifts into insolvency; and it minimizes the taxpayers' role in this process while maximizing the contribution from the thrift industry itself.

I believe the administration's plan addresses these basic principles. What we are engaged in this morning is a review of the administration proposal to see whether it can meet these objectives without further change, or whether some modifications would be desirable. I am concerned, for example, and I hope Secretary Brady can shed some light on the subject this morning, that the thrift industry may not be able to raise sufficient funds to simultaneously: One, raise its capital to 6 percent, two, eliminate its use of good will on its balance sheets, and three, provide the funds to purchase the $50 billion in zero-coupon bonds the administration plan requires. I think it is absolutely vital that the thrift industry make the maximum contribution it can make to the solution of this problem. On the other hand, I do not see how we can ever get a permanent solution if our proposal leaves even the profitable part of the thrift industry in such a weakened condition that it cannot earn a profit in the future.

I am also concerned about the size of the administration's package. The financing part of the proposal needs to meet three needs: One, provide funds to refinance the old cases if such refinancing would lower the overall cost of the financial assistance package; two, provide the funds to resolve the additional approximately 350 cases we know are out there and the other cases we can reasonably anticipate in the near future; and three, provide funds to recapitalize the FSLIC insurance fund for the future. I have some questions, given the details that have been released so far, as to whether the administration proposal fully meets the third objective. The Resolution Trust Corporation, as I understand it, will stop accepting new cases after 3 years. At that point, I am not certain that the new FSLIC account in the Federal Deposit Insurance Corporation will have the resources it needs to resolve cases that may arrive after that time.

These are only a couple of the issues that I am concerned about, but I want to tell Secretary Brady that I believe that all the members of the Senate Banking Committee want to work with him in a bipartisan manner to resolve this problem as quickly as we can. We have many difficult issues to work through, but I know if we work through them together, we can achieve the result that all of us want.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Mr. Chairman, let me join the chorus in thanking you for your leadership that has been so indispensable in this process. I am glad that after seven Congresses and two Presidents ran away from this problem that our new President right out of the chute stepped up with a real plan to deal with it.

And, Nick, having at least gotten an opportunity to look at the bill, 333 pages, just a little over $150 million a page, you don't get bargains like that in Washington any more, and I want, Mr. Chairman, to sign on as an original cosponsor if you would have my name.

Nick, I think you are going to have an opportunity here that often people don't like after they get it, and that is you are going to get pretty much what you want in this plan. I think it is a tough assignment, trying to fill up a big hole out there financially. I think it is critically important that the job get done as quickly as possible.

I have some concerns about little bits and pieces of the bill, but in terms of the overall thrust I think it is a good proposal. I think probably it does as much as we could do to assure that to the extent that the proposal is successful, to the extent that the southwestern part of the country recovers economically, that the taxpayer has a fighting chance to be made whole.

I think the bill goes about as far as you can go in trying to go after the people who have profiteered at the expense ultimately of the taxpayer, and I think that is critically important. I think it asks for the reforms that are needed to assure that at least we have a good chance of never having to go down this road again, and so while I think there are some goals in it that may be a little unrealistic in terms of achieving, for example, a 6-percent capital level in 2 years, that might be possible in heaven. Whether it is going to be possible in Texas or not I think is debatable.

But overall, Mr. Chairman, I think it is a good start. It is a good bill, and my guess is that after we have looked at it and tried to see how it might be reformed in a major way we will decide to give Nick Brady what he asks for, and I look forward not only to working on the bill and see it signed into law, but working with you to try to make this a success not just for assuring the depositors but trying to get the taxpayers' money back.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Graham.

OPENING STATEMENT OF SENATOR GRAHAM

Senator GRAHAM. Thank you, Mr. Chairman.

I wish to also commend you for your strong leadership in placing this committee in a position to deal so expeditiously with this matter. We already have had some remarkable things occur, including the statement just made by my friend from Texas, which indicates that heaven and Texas are two different places. I had always thought they were synonymous.

I am particularly pleased that Secretary Brady is with us today in order to give us an opportunity to fully understand the administration's plan.

Secretary Brady and I had a telephone conversation in October over the wisdom of how to approach this issue, whether it should be through a commission that would include a broad range of thought on the matter or through the Treasury. Secretary Brady had control of that question, and I commend him for having brought us so expeditiously through the process that he preferred, a base upon which we can commence this debate.

I have three specific concerns, one a short term concern, and that is the sliding institutions, and I note in today's news story that the Secretary has indicated that there is another tier of 150, plus or minus, institutions waiting behind those that are already insolvent. I am anxious that we take such steps as are necessary in order to attempt to avoid those institutions going into insolvency.

Second, the long term question of the stability of our financial institutions, I think the basic question, is of the relationship between the political aspects of our Government and the financial regulatory system that are being raised by these proposals. Do we want to move toward a European Ministry of Finance approach to the relationship between government and its financial regulatory agencies? I think that is a basic issue raised by the proposal.

And, finally, an ethical question. We are about to decide how to pay for a decade of misdeeds largely by passing that decade of imprudence on to the next generation. If that is to be the approach, I think it is absolutely necessary that we do so at the lowest possible cost to those future generations. To do otherwise would be to add ethical violation on top of ethical misdeed.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Graham.

Senator D'Amato.

OPENING REMARKS OF SENATOR D'AMATO

Senator D'Amato. Thank you, Mr. Chairman.

Mr. Chairman, I am going to ask that my statement be included in the record as if read in its entirety, and if there is time, I am going to simply indicate to the Secretary it is good to see him and congratulate him and the President for coming forth with a plan.

You have heard all the admonitions, but I think most importantly at least we are addressing this quickly, with dispatch. There obviously will be some modifications, some changes that you will yourself, Mr. Secretary, and the administration will seek to make, but I think it is with a great sense of bipartisanship and cooperation both from the executive and from the legislative that we do embark upon moving this.

I congratulate you for it.

[The complete prepared statement of Senator D'Amato follows:]

STATEMENT OF SENATOR D'AMATO

Senator D'Amato. I would like to offer my own welcome to Secretary Brady and also welcome the sense of urgency which the administration has added to this process. As we all know the FSLIC deficit will grow until such time as the Congress acts and provides funds to close or merge failed institutions. I commend the Bush administration's swift action in taking control of insolvent institutions because it sets the stage for swift legislative action. I again urge my colleagues on the committee and all others who are concerned to address the hard issues now so that we hasten the day when we actually put an end to this crisis.

I would also like to reiterate my position regarding the type of reform we must legislate. To assure ourselves that the taxpayers will not face such a situation again we can rely on improved regulation, tough supervision and stringent enforcement of the law. However, we must also be aware that we in the Congress will, through legislation, determine the future purpose and the future viability of the thrift industry.

The large and healthy majority of savings and loans have proven over time to be the bulwark of the home mortgage lending industry. Homeownership and affordable housing continue to reside at the heart of the American dream. Even over the past few years of high deposit insurance premiums and high cost of funds, healthy thrifts have continued to help people realize the dream of owning a home. Among our other priorities we must keep this important purpose in mind.

The administration's proposal takes several steps toward restructuring the Federal Home Loan Bank System. Many of these steps such as increasing capital requirements and making the FSLIC independent of the industry are reforms long overdue. Other aspects of the proposal are more complex and warrant serious study. Moreover, as we review each reform proposal we must remember that a revitalized and efficient thrift industry should be the ultimate result of the Congress' reform efforts.

Finally, I reiterate the importance of eliminating forever the fraudulent and overreaching element that has played a large role in bringing down the thrift industry in many parts of the country. As I have stated before, bringing the thieves to justice and recovering the stolen assets must be the top priority. I urge Secretary Brady to fully assist the Justice Department in its efforts to track down and convict those who have broken the law and raided the deposit insurance fund.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator D'Amato.

Senator Sanford.

OPENING STATEMENT OF SENATOR SANFORD

Senator SANFORD. Thank you very much, Mr. Chairman.

I am pleased to welcome you here, Mr. Secretary, and to thank you for your leadership in coming up with the plan. I certainly applaud the administration for its efforts. I commend the plan in general, but I think it would be a mistake to think that it is going to whip through just as it is.

While the plan is broad enough and deep enough to be an excellent starting point, but there are some things that probably need some adjustment, and I feel certain that that will be the attitude as we go forward.

I am of the opinion that the healthy savings institutions now operating are not responsible for the problems that the whole industry faces. In my State we may have four, possibly six, but most likely four institutions that are in trouble. Most of the thrift executives believe that they have done the best they could to resist the lax practices permitted, or indeed encouraged, by the regulators. Two administrations haven't stepped up to address the regulatory and financial problems facing the FSLIC or two administrations have permitted very sloppy regulations. The fault for much of the loss we are facing is indeed on the Government and on Congress, who deregulated the savings and loan industry, but then didn't provide adequate supervision.

My point is that I don't think we can put too much of the burden of this cleanup on the healthy savings institutions. If we do, we run counter to what you have so well-stated in your testimony, Secretary Brady, and that is that we need a healthy home loan, individual home loan industry. We have got a good home loan industry if we will just clean up the mess in the insurance and regulatory side.

My position is that we have got to find a solution, but not one that destroys all the healthy institutions.

Two things would tend to destroy too many healthy institutions. One is the almost unlimited right that would be given FDIC to increase premiums while almost immediately, on the other hand, requiring greater capitalization.

There is not any way unless they can make profits that a savings institution can increase capitalization in such a short period of time. I would hope that we could require a steady progress toward increasing capitalization without presenting a very quick deadline to double capital.

If the burden of higher premiums and higher capital standards can be worked out in a way that adds to the health of the industry but doesn't unduly penalize the companies that have been run properly, then we will have achieved a successful bailout plan.

I thank you again. I look forward to working with you. I share Senator Graham's concern that we should find a cheaper, better way of financing this, but that, too, can be discussed more fully as we go along.

Thank you very much.

The CHAIRMAN. Senator Sanford, let me just use your comment as an occasion to say to all members that we distributed yesterday to each member's office a summary of the profile of the savings and loans in their own individual States to get an idea as to the condition of various net worth calculations, above 6 percent, below 6 percent, and so forth, and we have a second copy of that here today for each member to get some sense as to what the profile looks like State by State.

We also have that information, of course, for the whole country. That is available by summary and by individual State.

Senator Bond.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Thank you, Mr. Chairman.

I join my colleagues in welcoming Secretary Brady to the Banking Committee, and I join in the praise for the administration's speed in coming up with a workable plan to deal with the savings and loan crisis.

I don't think, as some have suggested already, that we need to spend a lot of time pointing fingers at previous administrations or regulators. I think we have to acknowledge that Congress had a very major role to play in this. This is the kind of disaster that really requires a team effort that goes beyond any one administration, Congress, regulators, or industry.

I want to thank the chairman for providing the information on the savings and loans in our State, and I will not trade with my friend from Texas. He made a kind offer. But we are encouraged to see the number of very healthy savings and loans in our State and that exist around the country.

I want to commend you, Mr. Chairman, for your very strong reassurance to depositors in savings and loans across the country. We have found in our State the need to do so as a result of recent news media published reports. There have been significant withdrawals in a number of areas. As we have emphasized in our State—and we have said so clearly—it is not necessary to do so. FSLIC will protect the depositors, and any type of fast withdrawal can only make the problem worse.

Nick, none of us here this morning, I am sure, are going to agree with every detail of your plan, but you have given us a very good starting point. We will have some changes and probably fuss over some of the provisions, but you have done us all a great service, I think, in coming up with a plan that is a reasonably fair allocation of the pain.

There is no pleasure here. There is a lot of pain. The only question is how we allocate it.

In my view, it is vital that the closing of insolvent thrifts be linked to the reform package. It is gratifying to see that the administration shares this point of view. No dough without a change in the structure and adequate enforcement provisions.

I am particularly pleased with the section on the proposed penalties and enforcement, where I believe vigilant, competent regulation of federally insured institutions and tough prosecution and penalties for criminal fraud are vital to ensure this does not happen again. I will not support an S&L package that does not include such criminal provisions as well as resources to pursue the recovery against malfeasers to the greatest extent possible.

As you know, I previously introduced legislation stiffening the penalties for defrauding a financial institution. I am delighted to see similar provisions in your proposal and, to my friend from Pennsylvania, who has taken flight with analogies of ducks, swans, and other water birds, I would only assure him that we will have more order and less odor on this committee when we find a way to administer the coup de grace to his fowl metaphors. [Laughter.]

Mr. Secretary, we welcome your testimony.

The CHAIRMAN. Thank you, Senator Bond.

Senator Bryan.

OPENING STATEMENT OF SENATOR BRYAN

Senator BRYAN. Mr. Chairman, let me also commend you as the chairman of this committee for bringing these matters to our attention at an early time.

I agree with the comments that have been made that action must be taken soon because the problem is going to get worse if we don't do so.

I am in a State that fortunately doesn't have the savings and loans institutions that face the kind of problems which dominate the front page, but it is my view that if action isn't taken soon there are going to be some healthy institutions that slide into that category.

I believe the administration deserves credit for stepping up to the plate early and taking a slice at this. I think what is important for us is to link the reform element as well as the financial piece of the solution. I am not prepared to support any action that does not have an element of reform so that we do not revisit this problem in 5, 10, or 15 years down the line.

Mr. Chairman, I am most interested to hear the testimony, and I will question the Secretary at that time.

Thank you very much.

The CHAIRMAN. Thank you, Senator Bryan.

Senator Kassebaum.

Senator KASSEBAUM. Thank you, Mr. Chairman.

I am looking forward to hearing Secretary Brady's testimony and to questioning him afterward.

The CHAIRMAN. Thank you very much.

Senator Mack.

OPENING STATEMENT OF SENATOR MACK

Senator **Mack**. Thank you very much, Mr. Chairman.

Welcome, Mr. Secretary.

Just a few comments. I have several areas of concern. One has to do with the capital provision; that is, the attempt by 1991 to raise the remaining savings and loans to in essence the 6 percent capital range.

The concern comes from the impact that the increased fees will have on profitability and the question, will that reduced profitability allow the institutions to reach that capital base.

The other areas would be—again, we all are saying we want to do what is necessary to make sure that it never happens again, and we hope that over the period of the next several days or next several weeks we will have an opportunity to address what role, if any, there should be with taking a look at some reform with respect to Federal deposit insurance.

As I understand, the single largest contingent liability on the part of the taxpayer is in fact the contingent liability related to Federal deposit insurance. As I understand it at this time, there really is no way to control the growth of that contingent liability.

So those are a couple of areas that I have concern.

Obviously, like the other members of this committee, I, too, think that the initiatives that you have taken and the administration has taken to come forward with a proposal this early in the new administration is to be commended, and I look forward to working with you in trying to solve this problem.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Mack.

Senator Pressler.

OPENING STATEMENT OF SENATOR PRESSLER

Senator **Pressler**. Thank you, Mr. Chairman.

I, too, want to welcome the Secretary and say I think that we do have to tackle this problem very quickly. If we had done it 2 or 3 years ago, I think we would have been much better off.

I mentioned earlier that I spent last week visiting 16 towns in South Dakota, where there are a lot of small banks and savings and loans, none of which got into trouble because they have very conservative practices, and the feeling there is why should we have to pay for the sins of others.

But that is something that we will have to work out here.

But one thing for certain—and I agree with my colleagues—that we should not allow this problem to repeat itself in banks or other institutions. The word "deregulation" is floated around a lot, and I have opposed most of those deregulation bills. But let's not repeat the problem by letting Government guarantee moneys be used for all sorts of speculation.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Pressler.

Before we begin the questioning, I have statements from Senators Cranston, Sasser, and Shelby to be inserted in the record.

STATEMENT OF SENATOR ALAN CRANSTON

Senator Cranston. I commend President Bush for moving quickly and comprehensively to deal with the problems facing the savings and loan industry and the Federal Savings and Loan Insurance Corporation [FSLIC]. I would like to welcome Secretary Brady, who is testifying for the first time before this committee in his new job as Secretary of the Treasury.

As we consider the need to adquately recapitalize FSLIC and grapple with the very difficult task of assuring ourselves and the American taxpayer that the thrift problem will not reoccur or spread to the commercial banking industry, there can be no doubt that broad financial reform and a reconciliation of the anomalies that exist between banks and thrift holding companies must be considered.

In many respects, the very nature of today's FSLIC crisis is but a microcosm of systemic problems facing the entire financial services industry. In the thrift crisis, we have been witnessing in part the disintegration of an outdated structure that was designed to restrict competition among various sectors of the financial industry in the belief that compartmentalization of products and services would enhance the overall safety of these institutions. We need a system that provides some rationale to the ground rules for all the players in the financial industry so that the public can feel that their funds are safe and sound in the future.

Although, I have not yet seen the details of the President's proposal, I have attended several briefings on the plan and I look forward to reading the Secretary's testimony.

Unfortunately, I cannot attend the hearing today, because of the state funeral of Emperor Hirohito of Japan, however I would like my statement printed in the record and I have some questions for the record also.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR JIM SASSER

Senator Sasser. Mr. Chairman, I am pleased that we will hear this morning from Secretary Brady on the administration's FSLIC proposal. I for one want to complement the President and the Secretary for coming forward early on with a serious and comprehensive proposal.

Yesterday, Dr. Alan Greenspan told the committee that the savings and loan situation was the greatest financial crisis to face this Nation in the postwar era. I'm inclined to agree.

That's why I think it's critically important that the administration is facing the question forthwith. Congress must follow suit.

Now this doesn't mean that I don't have reservations about certain aspects of the plan. Indeed, I am worried that the plan may underestimate the scope of the problem. I don't think that there is full recognition of the potential cost to the thrift insurance fund of the higher capital standards. It's possible that many additional thrifts will become insolvent because of the increased standards.

And the plan, as is the budget in general, is built around very rosy economics, particularly an assumption of sharply declining interest rates. We heard Dr. Greenspan's views on inflation and interest rates yesterday. I think it's fair to say that, in contrast, he sees rates on an upward path—so this plan has some underlying problems.

Moreover, I am concerned that the off-budget treatment of the bonding may impose additional and unnecessary costs on the Treasury. The interest expense on these bonds will largely be met with public funds. However, the interest will necessarily be more expensive because the principal on the bonds themselves will be repaid from "private" sources.

Now we all know why the administration has structured its program this way—they're playing budgetary games. Mr. Chairman, I think that given the seriousness of this situation, and its enormous cost, it may be time for some honest economics and honest budgeting.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR RICHARD SHELBY

Senator **Shelby**. I want to join with my colleagues in welcoming Secretary Brady before this committee. His testimony on the Treasury's proposal has been much anticipated.

Secretary Brady, I'd like to begin by saying that I think that the Treasury has done a very good job of laying the foundations for a resolution to this crisis. Certainly it's a difficult issue and one for which a resolution is not easy nor simple. We have never faced a financial crisis of this magnitude; the size of this crisis is staggering even to the well-informed, not to mention the average taxpayer.

However, having said that I believe that the precepts of this plan are good, I must follow up by saying that I am very much concerned that it is based on an unrealistic set of assumptions. I haven't had a chance to study the numbers yet myself but I read in the papers that the proposal assumes S&L deposits will grow by 7.2% a year. This seems ludicrous in light of the outflow of deposits that we see even now. It seems that the only way to attract that sort of growth would be from the maintenance of the "Texas premium" and that's exactly the sort of the thing that the FDIC's presence is supposed to do away with. The proposal also assumes falling interest rates. Well, I commend your optimism and hope that you are correct but I believe it is foolish to set up a financing package contingent upon the "best case scenario."

In addition to these specific problems, I have a few broader concerns that I hope to see addressed in the final resolution package. First of all, and this goes without saying, I want to ensure that this never, ever happens again. Last week I visited 38 counties in my State and at each county meeting I was asked how a scandal of these dimensions was able to go for so long unchecked. I do not have a good answer; I would suggest that never have so many different entities been culpable of so much. The ultimate cost of $100 billion to $130 billion is the sum of fraud, greed, irresponsibility, myopia, and a laundry list of other sins. And now we're asking the taxpayer to foot the bill for part of the cleanup. I know we are all cognizant of this inequity so I will not belabor the point.

However, since the taxpayer must be included in the resolution, I want to ensure that his ultimate cost is minimized. While I recognize the difficulty of assessing accurately the value of many of these thrifts and their assets, I believe that it is important to include a maximum cap on the cost to the taxpayer. I am uncomfortable with open-ended plans, and that includes plans that rely on unrealistic assumptions, that commit the taxpayer to the difference between real revenues and real costs. It is preferable, in my judgment, to overestimate the cost to the Treasury, include the appropriate increments in the annual budgets, and let the Treasury benefit from the upside, should such an increase in value materialize.

Part of the unspecified cost to the taxpayer in this proposal comes from the method of servicing past FSLIC resolutions. Treasury is liable for the shortfall in FSLIC resources to meet these past commitments. I support efforts to appropriate as much as is feasible from the thrift industry but, as my colleague from Texas [Gramm] says, you can't get blood from a turnip. This proposal relies very heavily on thrift industry resources that I am just not convinced are there.

However, my principal concern, which is not explicitly addressed by this proposal is whether or not there is a continued need for a separate thrift industry. Thrifts now originate about 55 percent of conventional 1-4 family mortgages. They hold less than 35 percent of single family mortgages to the secondary market makers. The tremendous growth of the secondary market has greatly increased the availability of mortgage credit.

Thrifts originally filled a niche by making home mortgages when other financial institutions didn't want to be committed to long term assets. However, the liquidity provided by the secondary market has undermined the justification for a separately chartered, separately regulated industry because it has encouraged other participants in the marketplace to get into the mortgage business. Freddie Mac, for example, has purchased $369 billion in mortgages to date. This has assisted in the finance of 7.3 million homes. Citicorp is now the single largest originator of mortgages. In my State, only 20 percent of the total mortgage originations are made by thrifts.

The Treasury's proposal does not explicitly address the need for a distinct thrift industry. It does, however, initiate a process that would permit the gradual phase out of a separate industry. I commend the Treasury for leaving the door open; I myself am not sure whether or not that door should be open or closed but I believe that it is an issue that bears scrutiny. This proposal calls for a study of the deposit insurance system. It is not clear to me whether this study will include in its scope the changing role of the thrift industry in the mortgage origination business. If not, that is something I would like to see us include.

I will bring my comments to a close at this time because we are all looking forward to the testimony of our witness.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Secretary, you are back before a committee upon which you yourself served at one point. We are delighted to welcome you back today. We would like to hear from you at this time.

STATEMENT OF NICHOLAS F. BRADY, SECRETARY, DEPARTMENT OF THE TREASURY

Secretary BRADY. Thank you, Mr. Chairman. I want to thank you personally for all of the help and guidance that you have given as well as the ranking member, Senator Garn.

I feel as though I have come to know the gentlemen on the Banking Committee a lot better during the last month than I did when I was a member of this body. All the consulting and help that the committee has given to the Treasury during these past months is very gratefully received by those of us who are working on the problem.

I have foreshortened my written remarks, but unfortunately they are a little longer than I wanted them to be because we all know this is a complicated problem and I wanted to cover the subject fully.

Finally, before getting into full flight on my testimony, I want to thank Senator Heinz for not giving me the bird. [Laughter.]

The CHAIRMAN. I am not sure everybody in the room heard that.

Senator HEINZ. Mr. Chairman, I would like order. I don't think you should repeat it. [Laughter.]

Secretary BRADY. On the day when I was sworn in as the Secretary of the Treasury, the top priority has been to achieve a sound, responsible solution to the savings and loan crisis.

President Bush is correct. No simple or painless solution to this problem exists. Only 18 days after he was inaugurated, however, he announced the administration's plan. In so doing, President Bush affirmed our commitment to fix it now, fix it right, and fix it once and for all.

Two watchwords have guided us as we prepared a plan to solve this problem, "never again." Never again should a Federal insurance fund that protects depositors become insolvent. Never again should insolvent federally insured depository institutions remain open and operate without sufficient private risk capital.

Never again should risky activities permitted by individual States put the Federal deposit insurance fund in jeopardy.

And never again should fraud committed against financial institutions or depositors be treated as less than the most serious crime.

Never again should the savings and loan system, which is important to our commitment to available, affordable housing, be put in such jeopardy.

The administration plan meets these standards. It serves as a blueprint for comprehensive reform and sound financing. It assures the emergence of a healthy and strong S&L industry and, for this reason, is proindustry both for the S&L's and the housing industry they serve.

Moreover, it has the strong support of the Federal regulators. When the President announced his plan, he also called on Congress to join him with all possible speed in solving the S&L crisis.

Today I can report to you that a key part of the administrative reform is already under way. On February 7, the day after the President announced his plan, the Federal Savings and Loan Insurance Corporation, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Federal Reserve worked together to stabilize control of the remaining insolvent institutions and impede them from enlarging the S&L deficit. By that action, we should begin to reduce the cost of funds for banks as well as for savings and loan and to control the losses in the insolvent S&L's.

Moreover, our quick action will give us a head start on implementing the resolutions which will be executed as soon as Congress provides the necessary financing.

This joint supervisory operation was designed with several purposes in mind: First, to conserve the assets of troubled S&L institutions; second, to preserve day-to-day banking services for the public until a permanent resolution of the institutions' problems could be put into place.

Our objectives are to minimize operating losses, restrict unwarranted or unsound growth, eliminate speculative activities and destructive competition in deposit rates, and to get rid of waste, fraud, and insider abuse wherever it exists.

I would like to emphasize that, during this interim period, insured depositors remain fully protected. Basic customer services will not change, and each institution's employees will continue to conduct the day-to-day operations. These institutions are open, with deposits backed by the Federal Government, and ready to do business with their customers.

Given the magnitude of the problems that we face, expedited and stabilizing action provides an orderly transition to the new regulatory structure that we propose. We now ask for legislative action by Congress to put the reform and financing plan into place and finish the job.

In short, we have proposed a blueprint for reform. We now need your help to build a solid structure for the savings-and-loan industry to ensure a strong foundation for housing finance in the future.

The President has asked me to deliver to the bipartisan leadership of this committee our comprehensive plan. As Senator Riegle announced this morning, we gave the plan to Senator Garn and Senator Riegle in the original printings. We will try to get plans to the rest of the committee this afternoon.

We respectfully request that you introduce it today.

In his budget message to the joint session of Congress on February 9, President Bush called on the Congress to deliver a reform package to him in 45 days. We know this is a tall order, but I pledge to you the full cooperation of the Treasury and the administration.

Expedited action by the Congress and the executive branch will help to reassure the millions of American savers who rely on deposit insurance protection that we indeed have a safe and sound financial system that will continue to meet their saving and borrowing needs in the future.

To resolve the problem itself, our plan attempts to right the wrongs of the past. Consequently, an understanding of how the current problem arose will not only place our plan in the proper context but also explain why we have come forward with the detailed package we present to you today.

To ensure that the tremendous losses in the industry never happen again and to minimize the total cost of resolving the problem, the administration plan makes structural reforms a prerequisite for the use of any taxpayer funds and provides for the necessary funding to solve the problem now.

Numerous objectives outlined in my written text guided development of the plan. However, let me summarize the administration's reform proposal.

The current organization of the thrift system dates from the New Deal. As the events of the 1980's have demonstrated, this system is antiquated. Furthermore, the goals of the regulator as an industry advocate and insurer are inherently in conflict.

To correct this problem, the FSLIC will be separated from the Bank Board and attached administratively to the FDIC. This will create a strong, independent insurer with the overarching mission to protect depositors and to maintain the integrity of the deposit insurance fund.

The considerable administrative expertise of the two insurance corporations will be available to manage financial insurance and regulatory issues. While a single agency will be created, separate insurance funds will be maintained for commercial banks and for savings and loans.

I underline the following: The separate insurance funds will not be commingled and premiums from each industry will be used only for its own insurance fund.

The Chairman of the Federal Home Loan Bank System will continue to be the chartering authority for Federal savings and loan associations and mutual savings banks. He will supervise the Federal Home Loan Mortgage Corporation, and he will be the primary Federal supervisor of savings and loans.

The current board will be replaced by a single chairman. The chairman of the Federal Home Loan Bank system will be subject to the general direction of the Secretary of the Treasury in the same manner as the Comptroller of the Currency presently is.

The new Federal Home Loan Bank System Chairman will also be the head of the system of the 12 Federal Home Loan Banks, which currently make loans to member institutions and supervise and examine them as well.

The chief supervisory employee of each Federal Home Loan Bank will report directly to the chief supervisory officer in Washington. By separating the insurer from the chartering agency, more serious disciplinary standards designed to protect the integrity of federally insured deposits can be maintained.

In addition by subjecting the actions of the Federal Home Loan Bank System to oversight by the Treasury Department, the interests of the taxpayers can be more fully and consistently protected. This Treasury oversight has existed for national banks since the administration of President Abraham Lincoln.

These steps will create a system of checks and balances for savings and loans that more closely parallels that of commercial banks. It is critical that we exercise the proper degree of oversight. The reason is clear: Treasury funds are being used for the first time as part of the cleanup operation. Treasury oversight is essential to assure that these problems and the strain that they place on our financial system do not occur again.

Treasury oversight is essential to assure a strong and safe system for readily available home financing. We are experiencing the results today of an industry that collectively has not been adequately capitalized. We have learned a valuable lesson. Deposit insurance simply will not work without sufficient private capital at risk and up front.

The administration plan would increase safety and soundness standards for savings and loan institutions by requiring these institutions to meet standards equivalent to commercial bank capital and regulatory standards within a two-year period. This is consistent with the ongoing efforts of all Federal financial regulators, including the current Bank Board, to implement risk-based capital standards to ensure that sufficient private capital is at risk ahead of the deposit insurance fund. Again, private capital is the best assurance that the Federal insurance of deposits will not be exposed to undue risk and imprudent investment behavior.

The chairman of the Federal Home Loan Bank system will oversee and manage this transition period. When thrifts adopt risk-based capital standards equivalent to those under which banks will operate after 1992, home mortgages will actually require lower capital levels than other forms of lending.

Moreover, S&L's will be given 10 years to amortize the goodwill on their balance sheets. Some stockholders may suffer dilution of their holdings, but appropriately we are achieving a safer and stronger system where private capital stands ahead of the Government's insurance of deposits, giving taxpayers enhanced protection.

At the same time, we expect a lower cost of funds for the solvent portion of the industry once unnecessary competition from insolvent institutions is removed. Incentives for attracting new capital will further increase the amount of private capital protecting depositors. For example, bank holding companies will be permitted to acquire a failed or failing savings and loan without the existing cross-marketing and tandem restrictions. After two years, bank holding companies will be able to acquire any savings and loan without these restrictions.

The FDIC will be given enhanced authority to set insurance standards for all savings and loans, both federally and State-chartered. It will be able to restrict risky activities that have been authorized by some States in the past.

The FDIC also would have what we call a "fast whistle" to halt unsafe and unsound practices, while still protecting insured depositors.

A fundamental requirement of the administration plan is that the Federal deposit insurance funds are put on a sound basis. This can be accomplished by reestablishing the basic principle of industry-financed deposit insurance funds standing between any future industry problems and the taxpayer.

The cost of the S&L solution underscores the importance of requiring all Federal deposit funds to be adequately capitalized. Consistent with this mandate is the creation of a sound savings association insurance fund, not just after-the-fact financing for insolvent S&L's.

It is equally important that we shore up the commercial bank insurance fund. The FDIC insurance fund's reserve to insured deposit ratio has fallen to an estimated all-time low of 0.83 percent from its historical average of 1.40 percent. We propose increasing commercial bank premiums to bring the FDIC fund back in line with its historical reserve to deposit ratio to protect depositors and to protect taxpayers.

Specifically, we propose a gradual rise in the deposit insurance premiums paid by commercial banks. It is important to point out that this is the first statutory increase in the FDIC's deposit insurance premium since 1935. During the intervening years, the amount of deposits insured per depositor in any one institution has increased from $2,500 in 1933 to the current level of $100,000 today.

Let me emphasize, however, that all of the increased premium revenue paid by commercial banks will go to the FDIC insurance fund alone. Not one penny from the commercial banks will go to any S&L resolution or to the new savings association insurance fund.

The administration's reform plan also proposes to strengthen the national credit union share insurance fund by having it use accounting procedures comparable to those used by the FDIC and the FSLIC.

The NCUSIF is currently structured such that each insured credit union places and maintains one percent of its shares on deposit in the fund and treats that contribution as an asset on its balance sheet.

This contrasts with the practices of both the FSLIC and the FDIC in which insured institutions treat their premium contributions as expenses. As long as credit unions consider their contributions as assets, they will resist using these assets to cover insurance losses.

As part of the comprehensive reform package, we must ensure that fraud and financial institution crimes are pursued and punished as befitting their grave societal costs. The fraud and abuse are widespread and well known to the American public through news and media accounts.

Our proposal will add new enforcement authorities, increase penalties for fraud, and increase funding to provide for dramatically increased law enforcement staff and prosecutions. The scope of Federal regulators' enforcement authority will be broadened to include all insiders in addition to the managers of institutions. It will also grant regulators broad power to impose temporary cease-and-desist orders.

Maximum civil penalties will be raised to $1 million per day and maximum criminal penalties to 20 years, with mandatory minimum sentencing. Civil penalty authority will be given to the Justice Department for the first time. These civil penalties will be cumulative to criminal sanctions.

Also, we propose to add civil and criminal seizure and forfeiture authority similar to the forfeiture authority for drug and drug money laundering.

Today, as in the past, the S&L industry plays an important role in housing finance. The S&L industry's problems do not stem fundamentally from their traditional business of mortgage lending. Nonetheless, problems in the S&L industry are a threat to the viability of our housing finance system.

The administration's plan is designed explicitly to promote housing finance by revitalizing the S&L industry and the Federal Home Loan Bank System. The regulatory reforms outlined earlier as well as oversight by the Treasury of the Federal Home Loan Bank System will ensure a financially viable S&L industry to serve housing finance. We believe the best thing for housing finance in this country is a strong and sound S&L industry.

Finally, the plan provides funding not just to resolve insolvent S&L's, but also includes funding to establish a new S&L insurance fund for the future. The majority of S&L insurance premiums are allocated to this insurance fund. None would pay for REFCORP interest. And Treasury funds are allocated to the insurance fund as well, giving tangible proof of our commitment to the future of the industry as a provider of housing finance.

Let me describe the administration plan for restoring the S&L industry to financial health. It has three components:

First, $50 billion is being raised to resolve currently insolvent institutions and any other marginally solvent institutions which may become insolvent over the next several years;

Second, the plan ensures adequate servicing of the $40 billion in past FSLIC obligations;

Third, and perhaps most important, the plan provides $33 billion in financial resources necessary to put S&L deposit insurance on a sound financial basis for the future.

At the heart of the plan is the creation of a Resolution Trust Corporation, the RTC, for which the FDIC will be the primary manager. It is directed to resolve all S&L's which are now GAAP insolvent or would become so over the next three years.

The creation of this new corporation will serve several purposes: It will allow the isolation and containment of all insolvent S&Ls during the 3-year resolution process and will facilitate full and precise accounting of all the funds that are used. The RTC will seek to complete the resolution or other disposition of all insolvent institutions and their assets over a period of 5 years.

An oversight board, consisting of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, and the Attorney General, will monitor all RTC activities to ensure the most effective use of both private and public financial resources.

To accomplish the task, the RTC will have available $50 billion in new funding which is provided by the administration plan. The plan also provides funds to pay for the $40 billion that already has been committed to past FSLIC resolutions.

Finally, the plan will provide additional funds for handling insolvencies in the post-RTC period from 1992 to 1999, as well as to help build an insurance fund for the healthy S&L's, the savings association insurance fund—SAIF—which will be operated during this period.

Let me discuss now some specifics of the financing of the component parts of our plan. Further details are contained in the appendix to my testimony which includes materials provided this committee by the OMB.

To provide the $50 billion to the RTC, we will create a new separate privately owned corporation, the Resolution Funding Corporation, called REFCORP, which will issue $50 billion in long-term bonds to raise the needed funds. REFCORP will purchase zero-coupon long-term Treasury securities whose maturity value will be $50 billion at maturity, growing through compound interest. To assure the repayment of the principal of the bonds issued by REFCORP, funds to purchase these zero-coupon bonds will come exclusively from private sources.

First, the Federal Home Loan Banks will contribute about $2 billion of their retained earnings, which are currently allocated to, but not needed by, the existing financing corporation, FICO, plus approximately 20 percent of their annual addition to retained earnings or $300 million in 1989, 1990, and 1991.

The S&L's will contribute a portion of their insurance premiums. If necessary, proceeds from the sale of FSLIC receivership assets will be used as well.

No Treasury funds or guarantees will be used to repay any REFCORP principal. Interest payments on the REFCORP bonds will come from a combination of private and taxpayer sources. Federal Home Loan Banks, beginning in 1992, will contribute $300 million a year.

Second, the RTC will contribute a portion of the proceeds generated from the sale of receivership assets and any proceeds from warrants and equity participations which were taken in resolutions earlier.

Third, Treasury funds will be there to make up the shortfall if any. All Treasury funds used to service REFCORP interest will be scored for budget purposes in the year expended.

Funds for the second component of our plan, servicing the cost of the $40 billion in resolutions already completed by FSLIC, also will come from a combination of S&L industry and taxpayer sources. First, FICO will issue bonds under its remaining authority and contribute to proceeds.

Second, the S&L's will contribute a portion of their insurance premiums. In addition, FSLIC will contribute the proceeds realized from the sale of receivership assets taken in already completed resolutions as well as miscellaneous income.

Third, Treasury funds will be used to make up the shortfall.

The final component of the plan, managing future S&L insolvencies and building SAIF the new S&L insurance fund, during the post-RTC period, is funded again from a combination of S&L industry and taxpayer sources. The S&L's contribute a portion of their insurance premiums, and Treasury will contribute funds as needed.

The resources together provide about $3 billion a year to handle any insolvencies which occur in the 1992–99 period and, in addition, contribute at least $1 billion per year to building the new Savings Association Insurance Fund.

Assuming that $24 billion is used for post-RTC resolutions by 1999, the SAIF fund will contain just under $9 billion to support the healthy S&L's. Overall the plan contains $33 billion in post-RTC funds from 1992 to 1999 to manage future insolvencies and contribute to building a healthy new S&L insurance fund.

Found in the appendix to this testimony are a chart and a listing of sources and uses of funds, which may be of interest to the committee. The S&L industry will be a major beneficiary of restoring its own financial health. From the outset, the administration has stated that the S&L industry must, therefore, contribute its fair share before the Federal Government makes good on its pledge to protect insured depositors.

As you can see, the plan requires a combination of private industry and public sources throughout. We believe that the share demanded of the industry is indeed fair, but not so great as to jeopardize the viability of the healthy S&L industry which will emerge from the RTC resolution process. It will indeed be a healthy industry that emerges, one with an attractive and viable charter with a clean insurance fund and one prepared to provide its traditional support for home loan financing.

Is the capacity of the administration's plan sufficient to resolve those S&L's presently insolvent and those marginal institutions which will become insolvent? The answer, we believe, is yes.

To address the immediate problem, the Bank Board has already handled about 222 institutions in 1988. Funding for the estimated cost, about $40 billion, as mentioned, is contained in the plan. What remains to resolve in the near future is the roughly 350 institutions which are insolvent by GAAP measures and about 150 institutions which, while GAAP solvent, have negative tangible net worth.

These 500 institutions have about $18 billion of negative net worth and about $265 billion of assets. Importantly, the problems are concentrated in a relatively few institutions. Over 80 percent of the negative net worth is held in the most troubled 100 institutions.

How much will it cost, assuming all of this caseload of 500 institutions have to be resolved? That of course depends on a number of factors: Future interest rates, real estate prices, and the speed with which the FDIC can get to work.

Under likely scenarios, however, we estimate the size of the immediate problem as significantly under the $50 billion available to the RTC to handle it. To arrive at our estimate, we start with the $18 billion of negative tangible net worth. To that cost we add some fraction of the assets which will be lost in the process of liquidation. Our present estimate of the total cost is about $40 billion. Even under less likely scenarios which would make the problem worse, it is within the $50 billion available to the RTC.

Our best estimate of the size of the current problem, $40 billion for the resolutions completed by the Bank Board last year, plus something under $50 billion for the current caseload, is a total of about $90 billion. And it is in line with the estimates which have been published by the FDIC, the GAO, the Federal Reserve, and the Bank Board.

What happens if in the future even more than 500 S&L's, the RTC's caseload, must be resolved, as a number of commentators have suggested? Our plan already contains a substantial amount of funds to support the S&L industry. During the post-RTC period, 1992 to 1999, a total of about $24 billion will be available during this period to resolve any S&L's which become insolvent. This amount is in addition to about $9 billion which is allocated by the plan to building a healthy new insurance fund for the S&L industry in the future.

The administration's activity over the past few weeks should illustrate clearly our commitment to a long-lasting resolution of the S&L crisis. We have presented a structurally sound plan. We have delivered to you a balanced financing package that requires contributions from the S&L industry and also lives within the Government's means.

If there is one recurring theme that I heard and hear from my G-7 finance colleagues, it is this: They, like all investors in our capital markets, are closely watching our commitment to budget discipline and financial responsibility. Our expedited action will enhance both financial stability now and in the future.

In conclusion, the President's comprehensive solution to the savings and loan crisis, if enacted by Congress in a timely manner, will provide a sound, long-term answer to the savings and loan problem. We have already made a head start. The time to act is now. The cooperative supervisory action already being implemented by the FSLIC and the FDIC paves the way to begin case resolutions immediately once the Congress acts. We stand ready and eager to work with members of the committee and others to enact this plan into law as soon as possible. Working together we can recreate and rejuvenate the vital savings and loan industry which has so well served the Nation's homeowners in the past.

Mr. Chairman, I want to thank you again for your cooperation and all the members of this committee for their cooperation. And I will be glad to answer any questions the committee may have.

[The complete prepared statement of Secretary Brady follows:]

TESTIMONY OF THE HONORABLE
NICHOLAS F. BRADY
SECRETARY OF THE DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
WEDNESDAY, FEBRUARY 22, 1989

INTRODUCTION

Mr. Chairman, Senator Garn, and Members of the Committee.

From the day when I was sworn in as Secretary of the Treasury, a top priority has been to achieve a sound, responsible response to the savings and loan crisis. President Bush is correct: No simple or painless solution to this problem exists. Only eighteen days after he was inaugurated, however, he announced the Administration's plan. In doing so, President Bush reaffirmed our commitment to fix it now, fix it right, and fix it once and for all.

Two watch words guided us as we prepared a plan to solve this problem--NEVER AGAIN.

- o Never again should a federal insurance fund that protects depositors become insolvent.
- o Never again should insolvent federally-insured depository institutions remain open and operate without sufficient private risk capital.
- o Never again should risky activities permitted by individual states put the federal deposit insurance fund in jeopardy.
- o Never again should fraud committed against financial institutions or depositors be punished as if it were a victimless white-collar crime.
- o Never again should the nation's savings and loan system, which is important to our commitment to available, affordable housing, be put in jeopardy.

The Administration plan meets these standards. It serves as a blueprint for comprehensive reform and sound financing. It assures the emergence of a healthy and strong S&L industry and for this reason is pro-industry -- both for S&Ls and for the housing industry they serve. Moreover, it has the strong support of the federal regulators -- the Federal Reserve Board (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the Federal Home Loan Bank Board (Bank Board), and the Comptroller of the Currency (OCC).

When the President announced his plan, he also called on Congress to join him -- with all possible speed -- to solve the savings and loan crisis. Today I can report to you that a key part of the administrative reform is already underway.

On February 7, the day after the President announced his plan, the Federal Savings and Loan Insurance Corporation (FSLIC), FDIC, OCC, and the Federal Reserve worked together to stabilize control of the remaining insolvent institutions and impede them from enlarging the S&L deficit. By that action we should begin to reduce the cost of funds over time -- for banks, as well as for savings and loans -- and to control the losses in the insolvent S&Ls. Moreover, our quick action will give us a head start on consummating the resolutions, which will be executed as soon as Congress provides the necessary financing.

This joint supervisory operation was designed with several purposes in mind: first, to conserve the assets of troubled savings institutions; and second, to preserve day-to-day banking services for the public until a permanent resolution of the institutions' problems can be put in place.

Our objectives are to minimize operating losses, restrict unwarranted or unsound growth, eliminate speculative activities and destructive competition in deposit rates, and to get rid of waste, fraud, and insider abuse wherever it exists.

I would like to emphasize that during this interim period, insured depositors remain fully protected, basic customer services will not change, and each institution's employees will continue to conduct the normal day-to-day operations of the institution. These institutions are open, with deposits backed by the federal government, and ready to do business with their customers.

The supervisory and resolution personnel of the FDIC and the other agencies are preparing for resolutions and are in a good position to act swiftly once the legislation is in place. This early start on the cooperative supervisory process saves us both time and money. Fast action by all parties -- the Administration, the regulators, and the Congress -- will help reduce the industry's cost of funds by getting the insolvent institutions resolved, out of the marketplace, and out of the business of needlessly bidding up interest rates.

Given the magnitude of the problems we face, expedited and stabilizing action provides an orderly transition to the new regulatory structure we propose. We now need legislative action by the Congress to put the reform and financing plan into place to finish the job.

In short, we have proposed a blueprint for reform. We now need your help to build a solid structure for the savings and loan industry to ensure a strong foundation for housing finance in the future. The President has asked me to deliver to the bipartisan leadership of this Committee our comprehensive plan. We respectfully request that you introduce it today. In his budget message to the joint session of Congress on February 9, President Bush called on the Congress to deliver a reform package to him in 45 days. Once Congress acts, we will be ready to move to stem the hemorrhaging.

This is a tall order, but I pledge to you the full cooperation of the Administration. Cooperative and expedited action by the Congress and the Executive branch will help to reassure the millions of American savers, who rely on deposit insurance protection, that we indeed have a safe and sound financial system that will continue to meet their saving and borrowing needs in the future.

THE SAVINGS AND LOAN PROBLEM

Our plan attempts to right the wrongs of the past. Consequently, an understanding of how the current problem arose will not only place our plan in the proper context, but also explain why we have come forward with the detailed package we present to you today.

Causes of the Problem

Inflation, Interest Rates, and Regulation Q. In the middle 1960s, savings and loans began experiencing liquidity and earnings problems caused by increased inflation and the resulting high, volatile interest rates. Mainly to protect these institutions from the effects of rising interest rates and excessive competition for funds from commercial banks, Congress, in 1966, placed commercial banks, mutual savings banks and savings and loans under deposit interest rate regulation (Regulation Q).

Consumer Demands for Market Rates. In the late 1970s, when rising inflation and interest rates exceeded Regulation Q ceilings, many savers became unwilling to limit themselves to the returns allowed under these artificially low interest rate ceilings. These savers withdrew their deposits from traditional savings accounts -- a process called disintermediation -- and invested them in newly-emerging, uninsured money market mutual funds. As a result of market forces, both consumers and depository institutions pressured Congress to remove the Regulation Q ceilings, which it did in the Depository Institutions Deregulation and Monetary Control Act of 1980.

Changes in Technology. Starting in the 1970s, the development of electronic technologies made it possible for funds to be withdrawn or shifted between institutions and across geographic boundaries instantaneously. Devices such as repurchase agreements for securities and certificates of deposit, marketed aggressively through brokers and underwriters, made it possible for institutions to draw depositors from a broad geographic base. They also enable depositors to withdraw their money from those institutions very quickly, thus permitting funds to flow to the highest bidder.

Furthermore, technological innovations made possible the securitization of mortgage loans. This development has allowed thrifts and non-thrifts to originate mortgages and sell them in the broader capital markets to investors such as insurance companies and pension funds. This, in turn, has increased competition and reduced the interest rate spreads and profit margins at banks and savings and loans.

Spread Problem. The high, short-term cost of deposits and lower embedded fixed rates on mortgages produced losses and drained capital from the S&L industry during the late 1970s and early 1980s. The industry's tangible capital fell from $28 billion in 1978 to $4 billion in 1982, a reduction of 85 percent.

Broadened Powers. In 1982, responding to the interest rate problems of thrifts, Congress passed the Garn-St Germain Depository Institutions Act. This law gave the Federal Home Loan Bank Board authority to substantially broaden the powers of Federally chartered thrift institutions. Subsequently, the Bank Board relaxed controls on consumer and commercial real estate lending.

Direct Investments. In response to the reduced spreads available in mortgage lending, some states permitted state-chartered savings and loans to diversify their asset portfolios. That change pulled capital away from residential mortgage loans and into significant amounts of direct investment in real estate and equity securities not permitted to federally-chartered institutions. State-chartered savings and loans that took advantage of these investments were still insured by the FSLIC, even though many of their investments extended beyond traditional home financing and were riskier than the activities Congress has authorized for federally-chartered institutions.

In the new regulatory environment, some institutions moved too quickly into activities for which they were unprepared. Regulators at all levels were slow to strengthen their supervision and enforcement capabilities. Diversification can be a healthy business practice, but proper supervisory practices are also required.

Inadequate Supervision Exacerbated by Deregulation. Supervisory and regulatory laxity in oversight also contributed to the current FSLIC problem. Inadequate capital requirements allowed thrifts to grow quickly with almost no "at-risk" capital. Low equity, in turn, encouraged greater risk taking. Belated authorization to issue adjustable rate mortgages prevented savings and loans from properly adjusting the maturity gap between deposits and mortgage loans. High turnover of the supervisory and examination personnel reduced the number and experience of much-needed industry watchdogs. And perhaps most disturbingly, the agency regulating the industry faced the often conflicting statutory goals of supervising, advocating, and insuring depository institutions in the name of promoting a stable housing finance market.

Imprudent Managers and Fraud. Compounding these problems has been the entry of some imprudent operators into the savings and loan industry. Managers used S&Ls and their authority to further their own business and other interests and not to foster traditional home financing.

Moreover, many of these "high fliers" used their institutions to finance lavish lifestyles and to engage in speculative and fraudulent business activities. Testimony to this effect was prepared by the Bank Board for presentation to the House Financial Institutions Subcommittee on June 9, 1987. An excellent report has been prepared by the House Government Operations Subcommittee chaired by Representative Doug Barnard.

The Justice Department continues to conduct large scale criminal investigations of financial institution fraud and embezzlement. As of September 30, 1988, 7,385 such investigations were open. Of these, 3,446 involved losses to institutions of $100,000 or more.

Attorney General Richard Thornburgh already has testified on the fraud problem confronting us. Estimates by the General Accounting Office (GAO) and others reveal that fraud may account for more than one-third of the failures in the S&L industry that we must now finance. The Federal Home Loan Bank Board's list of "significant" fraud cases turned over to the Justice Department involve institutions with total assets of $160 billion.

Economic Downturn in the Southwest. Finally, the economic downturn and general price deflation in the agricultural, real estate, and oil and gas sectors of the economy have created serious problems in the Southwest. Even well-managed thrift institutions in the Southwest now face widespread non-accruing loans, collateralized, in many cases, with non-salable properties.

Summary. In sum, consumer demand for increasing market interest rates on deposits, combined with both technological changes as well as high and volatile interest rates, resulted in negative interest rate spreads in the late 1970s and early 1980s. This, in turn, drastically reduced the industry's aggregate capital-to-asset ratio from 5.6 percent in 1979 to 2.9 percent in 1982. Once market interest rates declined, most institutions became profitable again. They started to rebuild their capital holdings. Other institutions, however, took advantage of the expanded state-authorized asset powers, the low capital requirements, and inadequate examination and supervision. The resulting problem portfolios were characterized by excessive risk and poor asset quality due to rapid growth. The economic downturn in the Southwest quickly reduced such portfolios to collections of non-earning assets.

OBJECTIVES OF THE ADMINISTRATION'S PLAN

To ensure that the tremendous losses in the industry never happen again and to minimize the total cost of resolving the problem, the Administration plan makes structural reforms a prerequisite for the use of any taxpayer funds and provides for the necessary funding to solve the problem now. The following Administration objectives guided the development of our plan:

- Reform -- a prerequisite to additional funding;
- A flexible financing plan of sufficient capacity to repair the damage;
- Institutional arrangements that lessen the disruption in the industry and avoid creating new government bureaucracies;
- Utilizing a fair level of S&L industry sources of funds before using taxpayer funds;
- Precise and trackable accounting for all public and private funds employed in resolving the S&L problem;
- Structural reforms that are sound, but practical enough to accommodate the market-driven changes that develop in any competitive industry;

- Funding for an adequate, on-going, self-financed savings association insurance fund, so that Treasury funds will not be needed again to bolster the deposit insurance funds;
- Protecting American taxpayers by assuring full financial and regulatory accountability through Treasury oversight; and
- Finally, sufficient private capital and industry-financed insurance funds standing between financial institution failures and the taxpayers.

OUTLINE OF THE PLAN

Let me summarize the Administration's comprehensive reform proposal in the following manner: first, by delineating the major structural reforms we seek; second, by providing an overview of the other reforms we propose; and, finally, by explaining how the resolution of the remaining insolvent institutions, which we have already begun, will be financed. The President's legislative package and the section-by-section analysis to be provided later give you all of the necessary details.

Structural Reforms

One Strong, Independent Insurance Administrator. The current organization of the thrift system dates from the New Deal. As the events of the 1980s have demonstrated, this system is antiquated. Furthermore, the goals of the regulator as an industry advocate and insurer are inherently in conflict. To correct this systemic problem, the FSLIC will be separated from the Bank Board and attached administratively to the FDIC (see Chart 1). This will create a strong, independent insurer with the over-arching mission to protect depositors and to maintain the integrity of the deposit insurance fund.

The considerable administrative expertise of the two corporations will be available to manage financial, insurance, and regulatory issues. While a single agency will be created, however, separate insurance funds will be maintained for commercial banks and for savings and loans. The separate insurance funds will not be commingled, and premiums from each industry will be used only for its own insurance fund.

The FDIC Board will be expanded from three to five members. Three members, including the Chairman, will be private citizens appointed by the President and confirmed by the Senate. The two remaining members will be the Comptroller of the Currency and the Chairman of the newly-renamed Federal Home Loan Bank System (FHLBS).

The Chairman of the FHLBS will continue to be the chartering authority for federal savings and loan associations and mutual savings banks, will supervise the Federal Home Loan Mortgage Corporation, and it will be the primary federal supervisor of savings and loans (see Chart 1). The current board will be replaced by a single chairman. The Chairman of the FHLBS will be subject to the general direction of the Secretary of the Treasury in the same manner as the Comptroller of the Currency. The new FHLBS Chairman will also be the head of the system of 12 Federal Home Loan Banks (FHLBanks), which currently make loans to member institutions and supervise and examine them as well. The chief supervisory employee of each FHLBank will report directly to the chief supervisory officer in Washington.

By separating the insurer from the chartering agency, more serious disciplinary standards designed to protect the integrity of federally-insured deposits can be maintained. In addition, by subjecting the actions of the FHLBS to oversight by the Treasury Department, the interests of the taxpayers can be more fully and consistently protected. This Treasury oversight has existed for national banks since the Administration of President Abraham Lincoln. These steps will create a system of checks and balances for savings and loans that more closely parallels that for commercial banks.

Some observers have already expressed reservations about Treasury oversight of the primary thrift supervisor in a manner that parallels our authority over national banks. Let me assure the Committee that we do not intend to micro-manage the revitalized Federal Home Loan Bank System. That concern led to our designating a chairman who would serve and function as a chief executive officer.

It is critical, however, that we exercise the proper degree of oversight. The reason is clear: Treasury funds are being used for the first time as part of the clean-up operation. Treasury oversight is essential to ensure that these problems and the strain they place on our financial system do not occur again. Treasury oversight is essential to ensure a strong and safe system for readily available home financing.

Enhanced Safety and Soundness Standards

Capital Requirements. We are experiencing the results today of an industry that collectively has not been adequately capitalized. We have learned a valuable lesson: Deposit insurance simply will not work without sufficient private capital at risk and up front.

The Administration plan will increase safety and soundness standards for savings and loan institutions by requiring these institutions to meet standards equivalent to commercial bank capital and regulatory standards within a two-year period. This is consistent with the on-going efforts of all the federal financial regulators, including the current Bank Board, to implement risk-based capital to ensure that sufficient private capital is at risk ahead of the deposit insurance fund. Again, private capital is the best assurance that the federal insurance of deposits will not be exposed to undue risk and imprudent investment behavior.

All savings and loans will be required to meet capital requirements equivalent to those for national banks by June 1, 1991. Some 1,240 savings and loans with total assets of $319 billion already meet this capital requirement, while the remaining 1,368 solvent institutions will be expected to raise the necessary capital internally or externally or by merging with stronger institutions.

The Chairman of the FHLBS will oversee and manage this transition period. When S&L capital standards become equivalent with those for banks, S&Ls could have a 50 percent break in the amount of required capital because of the treatment of home mortgage assets under the Basle capital agreement. Moreover, S&Ls will be given 10 years to amortize the goodwill on their balance sheets.

Some stockholders may suffer dilution of their holdings, but appropriately we are achieving a safer and stronger system where private capital stands ahead of the government's insurance of deposits, giving taxpayers enhanced protection. At the same time, we expect a lower cost of funds for the solvent portion of the industry once unfair competition from insolvent institutions is removed.

Incentives for New Capital. Incentives for attracting new capital will further increase the amount of private capital protecting depositors. Several barriers to the entry of traditional financial services companies will be eliminated. For example, bank holding companies will be permitted to acquire a failed or failing savings and loan without the existing cross-marketing and tandem restrictions. After two years, bank holding companies will be able to acquire any savings and loan without these restrictions.

Additional Supervisory Powers. The FDIC will be given enhanced authority to set insurance standards for all savings and loans, both federal and state-chartered. It will be able to restrict risky activities that have been authorized by some states in the past. The FDIC also would have a "fast whistle" to halt unsafe and unsound practices, while still protecting insured depositors. Furthermore, all insured depository institutions within holding companies would guarantee the insurance fund against loss in the event of the failure of any insured depository institution owned by the same holding company.

Putting Deposit Insurance on a Sound Financial Basis for the Future

There is a fundamental requirement that the federal deposit insurance funds are put on a sound financial basis. This can be accomplished by reestablishing the basic principle of industry-financed deposit insurance funds standing between any future industry problems and the taxpayer.

The cost of the S&L solution underscores the importance of requiring all federal deposit funds to be adequately capitalized. Consistent with this mandate is the creation of a sound savings association insurance fund, not just after-the-fact financing for insolvent S&Ls. It is equally important that we shore up the commercial bank insurance fund. The FDIC insurance fund's reserve-to-insured deposit ratio has fallen to an estimated all-time low of 0.83 percent from its historical average of 1.40 percent.

We propose increasing commercial bank premiums to bring the FDIC fund back in line with its historical reserve-to-deposit ratio to protect depositors and taxpayers. Specifically, we propose a gradual rise in the deposit insurance premiums paid by commercial banks from $.08 per $100 in deposits to $.15 per $100 in deposits by 1991. Premiums would be rebated when the bank insurance fund is in excess of a 1.25 percent reserve-to-deposit ratio.

It is important to point out that this is the first statutory increase in the FDIC's deposit insurance premium since 1935. During the intervening years, the amount of deposits insured per depositor in any one institution has increased from $2,500 in 1933 to the current level of $100,000.

Let me emphasize, however, that all of the increased premium revenue paid by commercial banks will go to the FDIC insurance fund; not one penny from commercial banks will go to any S&L resolution or to the new savings association insurance fund.

Emergency special assessment authority will be granted to the FDIC. The FDIC will be permitted to raise the overall premium level when the fund is too low, as well as to lower premiums when it is fully funded. Thus, risk-based capital and experience cost-based premiums will ensure that the costs to the funds are covered. The maximum cap on the premiums paid by commercial banks or S&Ls would be 35 basis points.

The Administration's reform plan also proposes to strengthen the National Credit Union Share Insurance Fund (NCUSIF) by having it use accounting procedures comparable to those used by the FDIC and FSLIC. The NCUSIF is currently structured such that each insured credit union places and maintains one percent of its shares on deposit in the fund and treats the contribution as an asset on its balance sheet. This contrasts with the practices of both the FSLIC and the FDIC in which insured institutions treat their premium contributions as expenses. As long as credit unions consider their contributions as assets, they will resist the using of these assets to cover insurance losses.

Therefore, we recommend that credit unions be required to expense the one percent of deposits they maintain at the NCUSIF over an 8-year transition period. During this transition period, no additional premiums would be collected. At the end of 8 years, the NCUSIF would avail itself of its existing statutory authority to collect a 1/12 of one percent premium.

Enhanced Enforcement Authority

As part of the comprehensive reform package, we must ensure that fraud and financial institution crimes are pursued and punished as befitting their grave societal costs. The fraud and abuse are widespread and well-known to the American public through news accounts. Our proposal will add new enforcement authorities, increase penalties for fraud, and increase funding to provide for dramatically increased law enforcement staff and prosecutions. The scope of federal regulators' enforcement authority will be broadened to include all insiders, in addition to the managers of an institution. It will also grant regulators broader power to impose temporary cease-and-desist orders.

We have borrowed a page from the Administration's war on drugs and drug money laundering in drafting our new enforcement authority. Maximum civil penalties will be raised to $1,000,000 per day, and maximum criminal penalties to 20 years, with

mandatory minimum sentencing. Authority will also be provided for regulatory agencies to pay rewards to informants. Civil penalty authority will be given to the Justice Department for the first time. These civil penalties will be cumulative to criminal sanctions. Also, we propose to add civil and criminal seizure and forfeiture authority similar to the forfeiture authority for drug and drug money laundering.

Most importantly, approximately $50 million per year would be authorized for three years for the Justice Department to fund a new national program to search out financial institution fraud. This program will include new investigators, auditors, analysts, and prosecutors trained in specialized and sophisticated methods of financial institution fraud. Indeed, the number of personnel devoted to investigating and prosecuting bank and thrift fraud will be approximately doubled.

A Revitalized Housing Finance System

Today, as in the past, the S&L industry plays an important role in housing finance. The S&L industry's problems do not stem fundamentally from their traditional business of mortgage financing. Nonetheless, problems in the S&L industry are a threat to the viability of our housing finance system.

The Administration's plan is designed explicitly to promote housing finance by revitalizing the S&L industry and the FHLBS. The regulatory reforms outlined earlier as well as oversight by Treasury of the FHLBS help insure a financially viable S&L industry to serve housing finance. We believe the best thing for housing finance in this country is a strong and sound S&L industry.

Moreover, the plan provides for explicit representation for the housing industry on the boards of directors of the regional Federal Home Loan Banks. The objective is to ensure that the concerns of the housing industry play a direct role in the policies and practices of these government sponsored enterprises.

Finally, the plan provides funding not just to resolve insolvent S&Ls, but also includes funding to establish a new S&L insurance fund for the future. The majority of future S&L insurance premiums are allocated to this insurance fund; none pay for REFCORP interest. And Treasury funds are allocated to the insurance fund as well, giving tangible proof of our commitment to the future of the S&L industry as a provider of housing finance.

Restoring the Industry to Financial Health

During 1988, the Bank Board resolved 205 institutions and stabilized 17 others. But the factors I have outlined combined to create such a problem that there still remain a total of about 350 S&Ls insolvent according to generally accepted accounting principles, or GAAP, and an additional roughly 150 which, while GAAP solvent, have negative tangible net worth. These institutions held about $265 billion in assets and had negative net worth on the order of $18 billion as of September 1988, the latest available figures.

Let me describe in some detail the Administration plan for restoring the S&L industry to financial health. It has three components. The first $50 billion is to resolve currently insolvent institutions and any other marginally solvent institutions which may become insolvent over the next several years. Secondly, the plan ensures adequate servicing of the $40 billion in past FSLIC obligations. And third, and perhaps most important, the plan provides $33 billion in financial resources necessary to put S&L deposit insurance on a sound financial basis for the future.

At the heart of our plan is the creation of a Resolution Trust Corporation (RTC), for which the FDIC will be the primary manager directed to resolve all S&Ls which are now GAAP insolvent or become so over the next three years (see chart 2). The creation of this new corporation will serve several practical business purposes: it will allow the isolation and containment of all insolvent S&Ls during the three-year resolution process and will facilitate a full and precise accounting of all the funds that are used. The RTC will seek to complete the resolution or other disposition of all insolvent institutions and their assets over a period of five years. An Oversight Board consisting of the Secretary of the Treasury, the Chairman of the Federal Reserve Board of Governors, and the Attorney General will monitor all RTC activities to ensure the most effective use of both private and public financial resources.

To accomplish its task, the RTC will have available $50 billion in new funding, which is provided by the Administration plan. The plan also provides funds to pay for the $40 billion that already has been committed in past FSLIC resolutions. Finally, the plan will provide additional funds for handling insolvencies in the post-RTC period from 1992 to 1999, as well as to help build an insurance fund for the healthy S&Ls -- the Savings Association Insurance Fund (SAIF) -- which will be operating during this period.

Let me discuss now some specifics of the financing of the various component parts of our plan. Further details are contained in the Appendix to my testimony which includes materials provided to this Committee by the Office of Management and Budget.

To provide the $50 billion to the RTC, we will create a new, separate, privately-owned corporation, the Resolution Funding Corporation (REFCORP), which will issue $50 billion in long-term bonds to raise the needed funds. REFCORP will purchase zero-coupon, long-term Treasury securities whose maturity value will be $50 billion -- growing through compound interest -- to assure the repayment of the principal of the bonds issued by REFCORP. Funds to purchase these zero-coupon bonds will come exclusively from private sources (see Chart 2):

- The FHLBanks will contribute about $2 billion of their retained earnings -- which are currently allocated to, but not needed by, the existing Financing Corporation (FICO) -- plus approximately 20% of their annual earnings, or $300 million, in 1989, 1990 and 1991;
- The S&Ls will contribute a portion of their insurance premiums; and
- If necessary, proceeds from the sale of FSLIC receivership assets will be used.

No Treasury funds or guarantees will be used to repay any REFCORP principal.

Interest payments on the REFCORP bonds will come from a combination of private and taxpayer sources:

- The FHLBanks, beginning in 1992, will contribute $300 million a year;
- The RTC will contribute a portion of the proceeds generated from the sale of receivership assets, and proceeds from warrants and equity participations taken in resolutions; and
- Treasury funds will make up any shortfall.

All Treasury funds used to service REFCORP interest will be scored for budget purposes in the year expended.

Funds for the second component of our plan -- servicing the cost of the $40 billion in resolutions already completed by FSLIC -- also will come from a combination of S&L industry and taxpayer sources:

- FICO will issue bonds under its remaining authority and contribute the proceeds;
- The S&Ls will contribute a portion of their insurance premiums;
- FSLIC will contribute the proceeds realized from the sale of receivership assets taken in already completed resolutions, as well as miscellaneous income; and
- Treasury funds will be used to make up any shortfall.

The final component of the plan -- managing future S&L insolvencies and building SAIF, the new S&L insurance fund, during the post-RTC period -- is funded again from a combination of S&L industry and taxpayer sources:

- The S&Ls contribute a portion of their insurance premiums; and
- Treasury will contribute funds as needed.

These sources together provide about $3 billion per year to handle any insolvencies which occur in the 1992-99 period and in addition contribute at least $1 billion per year to building the new Savings Association Insurance Fund. Assuming that $24 billion is used for post-RTC resolutions, by 1999 the SAIF fund will still contain just under $9 billion at a minimum to support the healthy S&Ls. Overall the plan contains $33 billion in post-RTC funds from 1992 to 1999 to manage future insolvencies and contribute to building a healthy new S&L insurance fund. Found in the appendix are a chart (Chart 3) and a listing of sources and uses of funds.

Throughout the plan, all Treasury funds used are fully scored for budget purposes and increase budget outlays as expended. The level of expected outlays falls within the margin provided for in President Reagan's FY 1990 budget and should not interfere with President Bush's commitment to meet the Gramm-Rudman deficit reduction goals in future years. Over the 1989-1999 period, we estimate the net increase in the deficit to be roughly $40 billion.

The S&L industry will be a major beneficiary of restoring its own financial health. From the outset, the Administration has stated that the S&L industry must therefore contribute its fair share -- before the Federal government makes good on its pledge to protect insured depositors. As you can see, the plan requires a combination of private industry and public sources throughout. We believe that the share demanded of the industry is indeed fair, but not so great as to jeopardize the viability of the healthy S&L industry which will emerge from the RTC resolution process. And it will indeed be a healthy industry that emerges -- one with an attractive and viable charter, with a clean insurance fund, and one prepared to provide its traditional support for home financing.

Is the capacity of the Administration's plan sufficient to resolve those S&Ls presently insolvent and those marginal institutions which will become insolvent? The answer is surely yes.

To address the immediate problem, the Bank Board has already handled about 222 institutions in 1988. Funding for the estimated cost -- about $40 billion -- is contained in our plan.

What remains to resolve in the near future is the roughly 350 institutions which are insolvent by GAAP measures and about 150 additional institutions which, while GAAP solvent, have negative tangible net worth. These 500 institutions have about $18 billion of negative net worth and about $265 billion of assets. Importantly, the problems are concentrated in a relatively few institutions -- over 80% of the negative net worth is held in the most troubled 100 institutions.

How much will it cost assuming all of this caseload of 500 institutions have to be resolved? That, of course, depends on a number of factors -- future interest rates, real estate prices and the speed with which the FDIC can get to work on the job. Under likely scenarios, we estimate the size of the immediate problem at well under the $50 billion available to the RTC to handle it. To get our estimate, we start with the $18 billion of negative tangible net worth. To that cost we add some fraction of the assets which will be lost in the process of liquidation or merger. Our present estimate of the total cost is about $40 billion. Even under less likely scenarios which would make the problem worse, it is within the $50 billion available to the RTC.

Our best estimate of the size of the current problem -- $40 billion for the resolutions completed by the Bank Board last year plus something under $50 billion for the current caseload, a total of about $90 billion -- is in line with estimates from the FDIC, GAO, Federal Reserve, and the Bank Board.

What happens if in the future even more that 350 GAAP insolvent and 150 GAAP solvent and tangible with negative tangible net worth must be resolved, as a number of commentators have suggested? Our plan already contains a substantial amount of funds to support the S&L industry during the post-RTC period, 1992-99. A total of about $24 billion will be available during this period to resolve any S&Ls which become insolvent. This amount is in addition to about $9 billion which is allocated by the plan to building a new insurance fund for the healthy S&Ls.

Should a presently implausible economic scenario occur which markedly increases the cost of the RTC resolution task -- either by increasing the cost of resolving the roughly 500 institutions with negative tangible net worth or by adding a large number of presently solvent institutions to its caseload -- some portion of the additional $24 billion capacity could be used. If they are not needed for resolutions, these funds will be available for use in further building the new S&L insurance fund.

CONCLUSION

The Administration's activity of the past few weeks should illustrate clearly our commitment to a long-lasting resolution of the S&L crisis. We have presented a structurally sound plan. We have delivered to you a balanced financing package that requires contributions from the S&L industry and also lives within the government's means. If there is one recurring theme that I hear from my G-7 finance colleagues, it is this: They -- like all investors in our capital markets -- are closely watching our commitment to budget discipline and financial responsibility. Our expedited action will enhance financial stability both now and in the future.

In conclusion, the President's comprehensive solution to the savings and loan crisis -- if enacted by Congress in a timely manner -- will provide a sound, long-term answer to the savings and loan problem. We already have made a head start. The time to act is now.

The cooperative supervisory action already being implemented by the FSLIC and the FDIC paves the way to begin case resolutions immediately once the Congress acts. We stand ready and eager to work with the Members of this Committee and others to enact this plan into law as soon as possible. Working together, we can recreate and rejuvenate the vital savings and loan industry, which has served the nation's home owners so well in the past.

I will be happy to answer any questions the Members of the Committee may have.

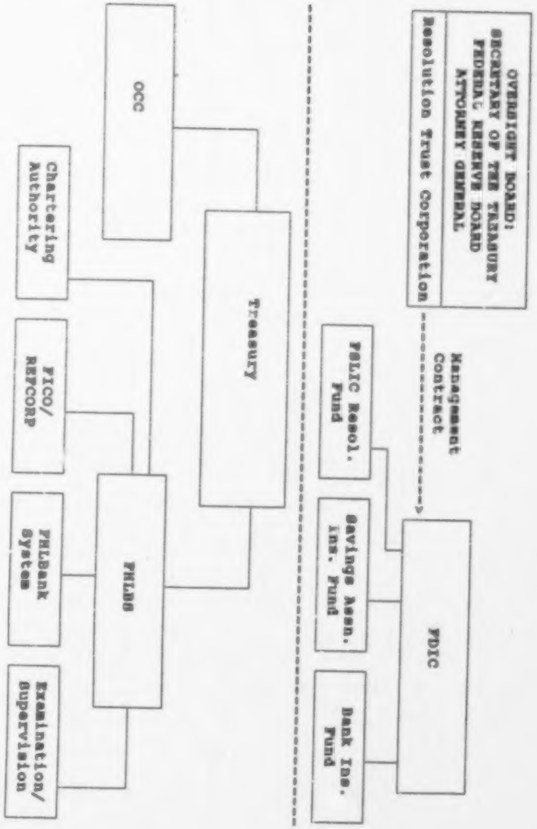
# # # # #

Priority of Sources of Funds

1. Commercial bank premiums:
    1) Bank Insurance Fund (Old FDIC fund)
2. Savings and Loan premiums:
    1) Interest on FICO bonds
    2) Principal for REFCORP bonds
    3) FSLIC Resolution Fund (Old FSLIC assets and liabilities)*
    4) Savings Association Insurance Fund*
        * 3 and 4 above switch to 4 and 3 in 1992
3. Old Receivership Proceeds:
    1) Principal for REFCORP
    2) Interest on FICO bonds
    3) FSLIC Resolution Fund
4. New Receivership Proceeds:
    1) Interest on REFCORP bonds
5. Warrants and Participations:
    1) Interest on REFCORP bonds
6. Miscellaneous FSLIC Income:
    1) FSLIC Resolution Fund
7. FHLBank Retained Earnings and $300 million in FHLBank Profits:
    1) Principal on FICO bonds
    2) Principal on REFCORP bonds
    3) Interest on REFCORP bonds
8. Treasury funds:
    1) Interest on REFCORP bonds
    2) FSLIC Resolution Fund
    3) Savings Association Insurance Fund (Schedule of estimated resolution costs plus $1 billion starting in 1991 until earlier of 1999 or reaching 1.25 ratio)
9. REFCORP Proceeds
    1) Resolution Trust Corporation (RTC)

Chart 1

General Organizational Structure

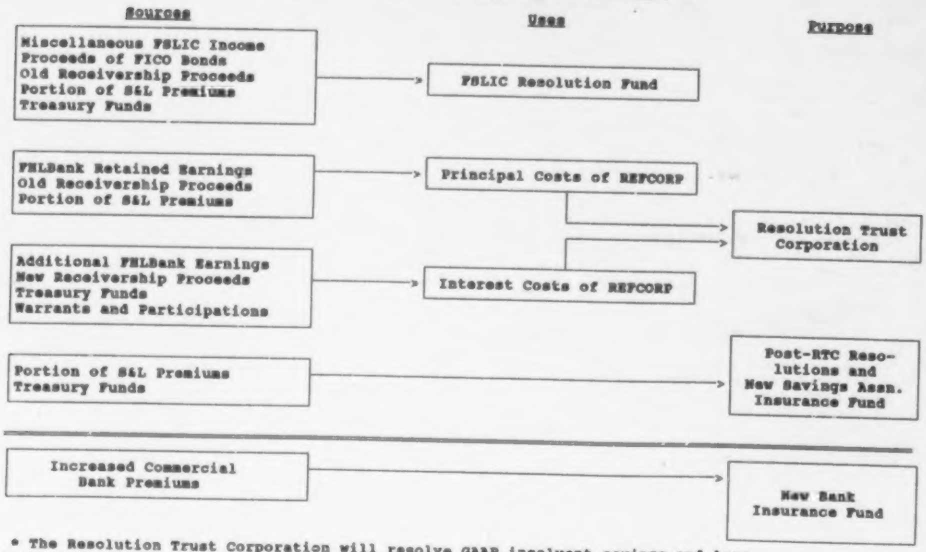

OVERSIGHT BOARD:
SECRETARY OF THE TREASURY
FEDERAL RESERVE BOARD
ATTORNEY GENERAL
Resolution Trust Corporation
Management Contract
FDIC
FSLIC Resol. Fund
Savings Assn. Ins. Fund
Bank Ins. Fund
Treasury
OCC
FHLBB
Chartering Authority
FICO/ REFCORP
FHLBank System
Examination/ Supervision

Priority of Uses of Funds

1. FDIC -- Bank Insurance Fund:
   1) Commercial bank premiums
2. FDIC -- Savings Association Insurance Fund:
   1) Savings and Loan premiums
   2) Treasury funds
   3) Offices and office supplies of FSLIC Resolution Fund (upon dissolution)
3. FSLIC Resolution Fund:
   1) Miscellaneous FSLIC income
   2) Proceeds of FICO bonds
   3) Old receivership proceeds
   4) S&L premiums
   5) Treasury funds
4. FICO Principal:
   1) FHLBank Retained Earnings and $300 million in FHLBank Profits
5. FICO Interest:
   1) S&L premiums
   2) Old receivership proceeds
6. REFCORP Principal:
   1) FHLBank Retained Earnings and $300 million in FHLBank Profits
   2) S&L premiums
   3) Old receivership proceeds
7. REFCORP Interest:
   1) New receivership proceeds
   2) Warrants and Participations
   3) FHLBank Retained Earnings and Profits
   4) Treasury funds
8. Resolution Trust Corporation (RTC):
   1) REFCORP proceeds ($50 billion)
9. Treasury:
   1) FSLIC Resolution Fund proceeds upon dissolution (net of offices and office supplies)
   2) REFCORP proceeds upon dissolution

Chart 3

SOURCES AND USES OF FUNDS
Resolution Trust Corporation * and
Resolution Funding Corporation (REFCORP) **

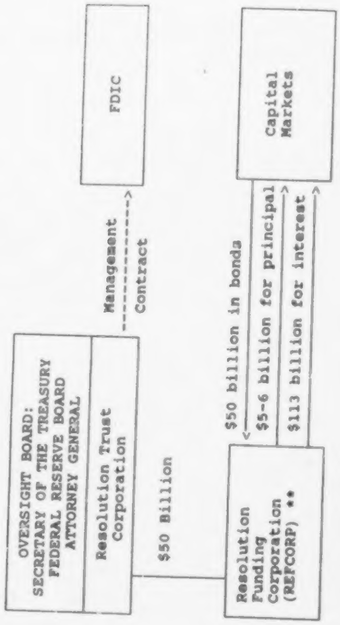

Sources
Uses
Purpose
Miscellaneous FSLIC Income
Proceeds of FICO Bonds
Old Receivership Proceeds
Portion of S&L Premiums
Treasury Funds
FSLIC Resolution Fund
FHLBank Retained Earnings
Old Receivership Proceeds
Portion of S&L Premiums
Principal Costs of REFCORP
Resolution Trust Corporation
Additional FHLBank Earnings
New Receivership Proceeds
Treasury Funds
Warrants and Participations
Interest Costs of REFCORP
Portion of S&L Premiums
Treasury Funds
Post-RTC Resolutions and New Savings Assn. Insurance Fund
Increased Commercial Bank Premiums
New Bank Insurance Fund

* The Resolution Trust Corporation will resolve GAAP insolvent savings and loans.

** The Resolution Funding Corporation will raise the $50 billion in bonds to finance the resolution operations of the RTC.

Chart 2

Insurance and Financing Structure


OVERSIGHT BOARD:
SECRETARY OF THE TREASURY
FEDERAL RESERVE BOARD
ATTORNEY GENERAL
Resolution Trust Corporation
Management Contract
FDIC
$50 Billion
Resolution Funding Corporation (REFCORP) **
$50 billion in bonds
$5-6 billion for principal
$113 billion for interest
Capital Markets

* The RTC will resolve all GAAP-insolvent S&Ls over a three-year period and will sunset after five years. NOTE: Although the RTC will contract with the FDIC, it will be subject to an Oversight Board composed of the Treasury Secretary, the Federal Reserve Chairman, and the Attorney General.

** The REFCORP will raise $50 billion in the capital markets, transfer that sum to the RTC for resolution costs for GAAP-insolvent S&Ls, and repay the principal and interest costs on the $50 billion.

Administration Proposal: Cash Flow for Government
($ in billions)

2/15/89

	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94	89-94	89-99
Cash Inflows (-):								
FSLIC/RTC collections from FICO	-3.8	-3.3					-7.1	-7.1
FSLIC/RTC collections from REFCORP	-10.0	-25.0	-15.0				-50.0	-50.0
S&L Premiums and other FSLIC Collections	-3.3	-1.5	-1.5	-3.2	-3.6	-3.5	-16.4	-31.2
Additional Collections to FDIC	0.0	-0.8	-1.6	-1.7	-1.8	-1.9	-7.9	-19.9
TOTAL CASH INFLOWS	-17.0	-30.6	-18.1	-4.9	-5.4	-5.5	-81.4	-108.2
Cash Outflows:								
Old Cases and administrative expenses -- cash	8.3	6.5	5.6	5.4	5.7	3.8	35.3	61.6
RTC cases	10.0	25.0	15.0				50.0	50.0
Post-RTC Cases			2.0	2.4	3.6	2.0	10.0	24.0
Contribution to REFCORP interest costs	0.5	1.4	1.6	0.9	0.8	1.1	6.3	22.0
TOTAL CASH OUTFLOWS	18.8	32.9	24.2	8.7	10.1	7.0	101.7	157.6
Net cash outflows	1.8	2.3	6.1	3.9	4.8	1.5	20.2	49.3
Debt transaction adjustments:								
New FSLIC debt issued	9.7	0.0	0.0	0.0	0.0	0.0	9.7	9.7
Redemption of FSLIC debt	-0.4	-0.3	-0.1	0.0	-1.1	0.0	-1.9	-19.2
NET COST TO GOVERNMENT (Budget Outlays)	11.1	1.9	6.0	3.8	3.7	1.5	28.1	39.9

FUNDING SUMMARY
($ in billions)

2/20/89

	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94	89-94	89-99
FSLIC/RTC Disbursements	27.7	31.2	22.5	7.8	8.3	5.8	103.2	126.2
Old Cases & Other Expenses	17.7	6.2	5.5	5.4	4.7	3.8	43.2	52.2
New Cases	10.0	25.0	17.0	2.4	3.6	2.0	60.0	74.0
Collections (-)	-17.0	-29.8	-16.5	-3.2	-3.6	-3.5	-73.5	-88.3
New FICO(REFCORP) Bonds	-10.0	-25.0	-15.0				-50.0	-50.0
Old Premiums (Net)	-1.4	0.4	0.3	-1.5	-1.5	-2.0	-5.6	-19.0
Additional Premium 1/			-0.3	-0.3	-0.3	0.4	-0.4	2.1
Other Old Collections	-5.6	-5.2	-1.6	-1.4	-1.8	-1.9	-17.5	-21.4
FSLIC/RTC Net Outlays	10.7	1.4	6.0	4.6	4.7	2.3	29.7	37.9
Treasury Payments for Bond (REFCORP) Interest	0.5	1.4	1.6	0.9	0.8	1.1	6.3	22.0
Add'l FDIC Collections	0.0	-0.8	-1.6	-1.7	-1.8	-1.9	-7.9	-19.9
TOTAL BUDGET OUTLAYS	11.1	1.9	6.0	3.8	3.7	1.5	28.1	39.9

1/ A (-) indicates increase in premiums, a (+) indicates a decrease.

02/20/89

NEW FICO (REFCORP) FINANCING
($ in billions)

	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94	89-94	89-99
NEW FICO (REFCORP) 1/								
PRINCIPAL covered by zeros paid with private funds:								
FHLB Retained Earnings	0.8	1.1	0.8	0.0	0.0	0.0	2.7	2.7
S&L Insurance Premiums	0.0	1.7	1.7	0.0	0.0	0.0	3.3	3.3
TOTAL DEFEASANCE	0.8	2.8	2.5	0.0	0.0	0.0	6.0	6.0
INTEREST covered by private & public funds:								
FHLB future income	0.0	0.0	0.0	0.3	0.3	0.3	0.9	2.4
Receivership Proceeds	0.0	0.5	1.8	2.6	2.7	2.4	10.0	12.0
Treasury funds	0.5	1.4	1.6	0.9	0.8	1.1	6.3	22.0
TOTAL INTEREST	0.5	1.9	3.4	3.8	3.8	3.8	17.2	36.4

1/ Sells long-term bonds: $10B in FY 89, $25B in FY 90, $15B in FY 91.

2/20/89

Assumptions	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94	
FICO (CEBA) Rates	9.0%	8.6%			wtd avg (88-90):		9.5%
REFCORP Rates	9.1%	7.9%	6.5%		wtd avg (89-91):		7.7%
Int Rate on LT Treasuries	8.0%	7.6%	6.2%		wtd avg (89-91):		7.4%
Discount on zeros	8.0%	7.6%	6.2%		wtd avg (89-91):		7.4%
Int Rate on FSLIC Notes	9.5%	7.8%	6.1%	4.9%	4.3%	4.0%	
FSLIC Deposit Base ($ in trillions)	1.0	1.1	1.2	1.2	1.3	1.4	
1989-99 Growth Rate	7.2%						
FDIC Deposit Base ($ in trillions)	2.1	2.3	2.4	2.6	2.8	2.9	
1989-99 Growth Rate	6.9%						

Recovery on receivership assets (new cases):
40 cents on each dollar over the 4 years subsequent to liquidation

2/15/89

($ in billions)

	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94	89-94	89-99
FSLIC & RTC ACCOUNT								
DISBURSEMENTS								
Old Cases & Other Expenses								
Admin and misc exp	0.3	0.3	0.3	0.3	0.3	0.2	1.6	2.8
Notes Issued	9.7						9.7	9.7
Interest on Notes Outstanding	1.4	1.5	1.1	0.9	0.8	0.7	6.4	9.2
Repay notes issued prior to FY 87	0.0	0.0	0.2	0.0	0.2	0.0	0.5	0.5
Assistance Payments	5.2	4.4	3.8	4.2	3.4	2.9	24.0	28.8
Liquidations	1.0						1.0	1.0
Total Old Cases and Other Exp	17.7	6.2	5.5	5.4	4.7	3.8	43.2	52.2
New Cases								
Assisted Mergers	5.0	12.5	8.5	1.2	1.8	1.0	30.0	46.0
Liquidations	5.0	12.5	8.5	1.2	1.8	1.0	30.0	30.0
Total New Cases	10.0	25.0	17.0	2.4	3.6	2.0	60.0	76.0
TOTAL DISBURSEMENTS	27.7	31.2	22.5	7.8	8.3	5.8	103.2	126.2
COLLECTIONS (-)								
FICO proceeds (CEBA) (-)	-3.8	-3.3					-7.1	-7.1
New REFCORP Proceeds (-)	-10.0	-25.0	-15.0				-50.0	-50.0
Insurance Premiums before deductions (-)	-2.1	-2.3	-2.7	-2.9	-3.1	-2.6	-15.6	-31.6
Deduct (+):								
FICO (CEBA) Interest	0.6	0.9	1.0	1.0	1.0	1.0	5.5	10.7
Sec. Reserve Credit	0.1	0.1	0.1	0.1	0.3	0.0	0.7	0.7
Defease New Bond Principal		1.7	1.7				3.3	3.3
Net Premium Income (-)	-1.4	0.4	0.1	-1.8	-1.7	-1.6	-6.0	-16.9
Proceeds from Receivers and Corporate-held Assets (old cases) (-)	-1.4	-1.4	-1.2	-1.0	-1.4	-1.5	-7.8	-9.7
Income on invest bal (-)	-0.1	0.0	0.0	0.0	-0.1	-0.1	-0.4	-1.1
Other Collections (-)	-0.4	-0.4	-0.4	-0.3	-0.3	-0.4	-2.1	-3.5
TOTAL COLLECTIONS	-17.0	-29.8	-16.5	-3.2	-3.6	-3.5	-73.5	-88.3
FSLIC/RTC NET OUTLAYS	10.7	1.4	6.0	4.6	4.7	2.3	29.7	37.9
Repayment of Notes Issued after FY 86	0.4	0.3	0.1	0.0	1.1	0.0	1.9	19.2
Balance of FSLIC Notes Outstanding (end-yr)	19.2	18.9	18.6	18.5	17.3	17.3	17.3	0.0
FSLIC/RTC Cash/Investment end-yr balances (9/30/88=$1.9B)								
balance for cases:	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5
balance for new fund:	0.0	0.0	0.0	1.0	2.1	3.2	3.2	8.8
SUMMARY OF ACCOUNTS AFFECTED								
FSLIC/RTC Net Outlays	10.7	1.4	6.0	4.6	4.7	2.3	29.7	37.9
Treasury Contribution to REFCORP Interest	0.5	1.4	1.6	0.9	0.8	1.1	6.3	27.0
Add'l FDIC Collections	0.0	-0.8	-1.6	-1.7	-1.8	-1.9	7.9	-10.9
TOTAL BUDGET OUTLAYS	11.1	1.9	6.0	3.8	3.7	1.5	28.1	50.9

The **Chairman**. Thank you very much, Mr. Secretary.

Let me say to those in the room that have had to stand because we have exhausted the supply of chairs, we have some additional chairs coming and we hope to be able to accommodate everyone with a chair in due course.

Let me start out in the first round here, Mr. Secretary, as follows:

It seems to me that in a sense, the plan provides two parts. There is the reform package and how we really structure this industry for the future. Then there is the question of how do we pay for the accumulated problem and how do we handle the financial side of this puzzle, both the workout of the accumulated problems and then putting it on a sound footing in the future.

Initially, I want to talk about the reform parts. I think the financing part we need to examine with great care and we are now in the process of doing that since we have gotten the source for the application of funds. There are a lot of assumptions built into that in terms of interest rates, deposit levels that will be achieved by S&L's, and the failure rates in the future and so forth.

So, much of that is very subjective. Already there is a lot of commentary on the question of whether or not the financing side is really adequate to do the job.

I think those are fair questions, and we are going to go through that in a most meticulous way.

Initially, however, I want to leave that part aside and deal with the reform part. I will start down through some issues in the time that I have.

On page 1 you have a very strong statement where you say, "Never again should the Nation's savings and loan system, which is important to our commitment to available, affordable housing, be put in jeopardy."

Then you emphasize and elaborate on that theme over on page 12, under the heading "A Revitalized Housing Finance System."

In the fourth paragraph you make a very strong argument for what one might think of as maintaining and keeping in the future a rather traditionally oriented savings and loan industry, something centered around housing finance.

You have given that a very strong emphasis in your presentation, and I just want to draw you out a little further on it.

Are we to conclude from what you have said in your presentation that the administration foresees a freestanding savings and loan industry extending out into the indefinite future, presumably, dedicated to the proposition of home mortgages and home lending? Is that a proper reading of what you are asserting here?

MAINTAIN A SAVINGS AND LOAN INDUSTRY

Secretary **Brady**. Mr. Chairman, that is a very fair summary of the administration's objectives, the reforms as you pointed out, that need to be taken care of. But at the bottom of all of this work is the desire to put the savings and loan on a sound financial basis so they can fulfill their traditional function of trying to provide home loan mortgages at the lowest possible rate.

The **Chairman**. Is it a fair conclusion, then, that the administration has reached the judgment that this is an important industry, it's to preserve and maintain, and it meets an important national need in the area of housing?

Secretary **Brady**. Exactly so.

The **Chairman**. Are you to the point yet where if the housing function—contributing to the development of housing and the building of housing units and the financing of mortgages for housing units and so forth—is the central thrust of the industry for the future, do you have a clear sense as to what the additional operating activities are that should be wrapped around that central function of the future operating charter of the savings and loans, as you see it?

Secretary **Brady**. Senator Riegle, are you referring to functions other than the financing of home loan mortgages?

The **Chairman**. That's right.

Secretary **Brady**. We have not yet determined precisely what exact rules and regulations the FDIC should insist on in return for a federally guaranteed insurance.

But one of the things that is in the plan is a risk- based capital plan which will attempt to put on the individual S&L's the onus for determining what sort of risks they take outside of financing home mortgages.

The idea of this is if they want to take greater risks, they have to allocate more capital to that risky activity.

The plan is not aimed at restricting the S&L's to purely home mortgages, but it is aimed at trying to make sure that the activities that they engage in are sound enough so that we don't have to do what we're doing today—developing a plan to bail out the industry.

The **Chairman**. I feel very keenly about that question because in a sense that is part of how this problem got loose. The State add-ons and operating authorities in the very liberal States have contributed importantly to the problem—that shows up in the profile of where the failed thrifts are, by and large.

Would you say that the housing charter ought to be as much, say, as 70 percent of the total future of what savings and loans do?

Secretary **Brady**. We haven't picked a figure. We thought that the FDIC, as it goes forward, would be in a better position to do that than we are in now.

But it is certainly our intent that a major portion of the S&L activity will be in that function for which they were created—housing finance.

The **Chairman**. Let me tell you one problem I see there. And my time will elapse here in a moment.

That is that regulators come and go. Sometimes you get a good one, sometimes you don't get such a good one and there are philosophic ways that come and go—tight regulation, deregulation.

It seems to me that when you've got a cleanup situation of this size in which you're working out of an enormous financial hole, the taxpayers are going to have to pay a large part of this, and that is a very unpleasant reality.

But in addition, we're going to go through a risk period where we want to make sure that the savings and loans that can strengthen themselves are able to do so and not slide backward and exhaust their strength and become basket cases in the future that require another secondary bailout later on down the line.

So, it seems to me the question of what constitutes the appropriate operating charter for the national housing need that you so forcefully describe has to be nailed down pretty clearly. And I don't want just to throw it up in the air and say, well, you know, we'll let the regulators think about it. I think we owe the public a much clearer roadmap into the future. And I think that would allow us to give them one.

Secretary BRADY. Your suggestion for a roadmap is a good one. I think when you mentioned an exact figure, I didn't pick up on that right away because I was thinking back to the days of the late 1970's and early 1980's when just the mere financing of home mortgages, because an inversion of interest rates, placed the savings and loan industry in an equally unsound position. Money was costing them more than the returns they were getting from home mortgages.

That is something to be guarded against as well. So, I think you have to work on that figure.

The CHAIRMAN. Let me just ask you one yes-or-no question and then I will turn it over to Senator Garn.

Does the record show that the bulk of the successful savings and loans in the country, those today with high capital ratios, good profitability that are not part of the problem, that the majority of those in a strong position have centered their activities around the traditional housing kind of focus and thrust.

Secretary BRADY. That is an extremely good point. I think it bodes well for the future that the great body of the successful savings and loans are ones that have stuck to their knitting and earned a decent, reasonable profit, not extraordinary profits, but a fair return for fair work. And I think that point is one that should be emphasized and reemphasized.

The CHAIRMAN. Thank you very much.

Senator Garn?

Senator GARN. Thank you, Mr. Chairman.

PUTTING THE FHLBB UNDER THE TREASURY

Mr. Secretary, as everyone knows, your proposal would place the Chairman of the Federal Home Loan Bank System under the Secretary of the Treasury, using the Office of the Comptroller of the Currency as a model.

As you know, this is one of the places we have a disagreement, and there has not been a disagreement, and there has not been a disagreement since the plan came out. I started talking about this back in December. I have made this point through all of our meetings, including a conversation I had with Governor Sununu from Camp David on Saturday when the decisions were being made. I have been asked by some if I am supporting the savings and loans position, although the question might be more accurately put, "Why are the savings and loans supporting my position?" [Laughter.]

My point being that I did not know what their position was. I started talking about this in my recommendations to you many, many weeks ago, prior to many of the options being noted publicly.

My reasons for that are, first of all, I don't think the Comptroller is a fair example. The Comptroller doesn't have 12 regional banks to supervise. The Comptroller doesn't have a housing component. In our hearing a couple of weeks ago I asked Paul Volcker that question. He testified to the committee that he would prefer to have it reconstituted as an independent board outside the Treasury.

In addition, many studies over the years have been critical of the fact that the OCC is within the Treasury Department and thus subject to political pressure rather than being independent.

For example, the Hunt Commission in 1971 called for a new consolidated independent bank regulatory agency separate from Treasury to replace OCC. In 1973, the House Banking Committee conducted an in-depth study and also recommended that banking regulations be consolidated outside the Treasury Department.

Likewise, the so-called Fein study in 1975 suggested consolidation of banking and thrift regulatory agencies into a new independent agency. Similar recommendations were also made in 1977 by the Senate Committee on Governmental Affairs.

So there has been a long history of independent committees saying let's take OCC out of Treasury and make them independent.

I also understand that the independence of the OCC has in fact been impinged upon on occasion. For example, the OCC was the last agency to sign on, even though it wanted to be on board right from the start, of the enforcement package introduced last year because of the bureaucracy holding that up. A few years ago, due to OMB objections, the OCC was not able to go along with the enhanced reporting requirements desired by banking agencies.

The history of the OCC reveals that in 1987 considerable pressure was brought to bear on the Comptroller by the Secretary of the Treasury to permit branching by banks owned by TransAmerica Corp.

I oppose placing the Federal Home Loan Bank Board Chairman under the Treasury because there is so much information from other sources that suggests that we should be going the other way and making OCC independent.

In light of the need for strongly independent bank and thrift regulators, wouldn't it make more sense to take the OCC out of Treasury and make it independent rather than having the new Chairman of the Federal Home Loan Bank System part of the Treasury? If the concern is that the Bank Board should not be a captive of the industry, which I understand—that criticism has been made for a number of years—why not make it more independent like the Fed or like the SEC?

Can you give me a justification for putting the Federal Home Loan Bank Board in with the bureaucracy of Treasury, rather than keeping it an independent agency answerable to the President? The SEC and the Fed have certainly been successful.

I am not concerned about you. I am not concerned about the Secretary. I am concerned about some of the gnomes in Treasury that I have worked with over the years. [Laughter.]

Secretary **Brady**. Senator, without responding to the question that you raised about the OCC, which maybe could be addressed at another day if you wish, I think you raised some very significant and well-taken points.

However, I would say there is a difference today. One is that we have a $90 billion problem on our hands and much as we may not like it, the solution to it is going to be financed by the taxpayers. So we have Treasury funds used as part of the solution to this problem. They will be spent over a period of years.

Unfortunately, we won't be able to cure this problem overnight. This is something that is going to take some care and feeding. It was our thought that while we are putting a great many industry funds into this solution, we are also putting a lot of taxpayer funds, and those taxpayer funds are coming from the Treasury. While they are being spent we think that the public would require that the Treasury carry on an oversight function.

On a personal level, I am reminded that the chairman of your committee called me on New Year's Eve, rather late on New Year's Eve, to ask me what was going on at the FSLIC and couldn't I please elucidate as to what these resolutions were. I had to tell him that the FSLIC was an independent agency and that I was unable to answer.

I thought through the problem, and it did occur to me that while we are spending Treasury funds Members of Congress and the public are entitled to call up some official who is responsible to bodies like this and get an answer.

So that is a long way to answer your question.

Senator **Garn**. First of all, the $90 billion is going to the FDIC, not to the Bank Board, and I don't disagree with what you are trying to accomplish. When you talk about Treasury funds, they are not Treasury funds. They are taxpayers' funds. They don't belong to Treasury.

That is why I used the analogy of the Fed or the SEC. The Fed is considered to be a very successful and efficient regulator, which produces over $17 billion of funds over and above their operating expenses paid into the general fund. Nobody is suggesting, with all that money involved year in and year out, that they need to be under Treasury or that the SEC needs to be under Treasury.

Again, my time is up on this round, and I certainly do support the overall plan, as I stated, but this is one point that I will continue to press—the Bank Board should be made more independent, not subject to Treasury.

The **Chairman**. Let me just say, Senator Garn, I know that the 5-minute time period is limiting, and I know you will probably want to pursue that and should pursue it at greater length. So we will make sure we find time for that this morning.

Before calling on Senator Sarbanes, I want to acknowledge that Senator Wirth has joined us. I know you had another hearing on that nuclear waste issue.

Do you have a brief opening comment?

Senator **Wirth**. Thank you very much, Mr. Chairman. My apologies for not being able to be here.

Secretary Brady, I think you have all done a really good start, and it is a far cry from what I remember under Secretary of the Treasury Gould saying to us last August:

> I urge this committee in the strongest possible terms to resist mounting pressure for an unnecessary budget busting bailout of the FSLIC.

I am glad we have all traveled a much more progressive road together here.

I am concerned, Mr. Chairman, and will be back in touch with you and with Mr. Seidman on the whole long term workout issue.

Mr. Brady, we have a lot of significant problems, as you know, in the State of Colorado, and the question is what happens to all of the property that is taken over by the FSLIC. I know the Resolution Trust Corporation will be set up, and our concern is how that is done and in such a way as to be very sensitive to the nature of an economy that is as fragile as ours is.

I am not putting that now at this point in the form of a question, Mr. Chairman, but I just wanted to alert Secretary Brady to the concerns of a large sector of the country about that set of issues.

I know you are sensitive to that, Mr. Secretary, and I appreciate your help. We will be back in touch.

Thank you very much for joining us. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Mr. Secretary, I would like to address this issue of State-chartered institutions that are given powers well beyond those that are deemed appropriate for federally chartered institutions or in fact have more lax regulatory standards.

Why should they be covered by Federal deposit insurance? Why should they be able to get into this system under that circumstance?

LIBERALLY REGULATED STATE-CHARTERED INSTITUTIONS

Secretary BRADY. Senator Sarbanes, I think that as long as the State powers are ones that conform to the newly created FDIC regulations and qualifications for insurance, they should be handled on a case-by-case basis.

Senator SARBANES. Who is going to determine those standards under your plan?

Secretary BRADY. The standards will be in the law, and therefore will be subject to debate during the period that the committee and Congress are examining these proposed laws. The idea is that there will be sufficient codification so that we can follow what is going on. But with the introduction of risk-based capital standards, the industry will have a chance to take some risks outside home mortgage financing itself. If they want to engage in slightly more risky activities, then they have to put up more capital.

Senator SARBANES. So they would have to hold to a higher capital standard?

Secretary BRADY. In the law we handed to Chairman Riegle this morning, we suggested that the capital requirements go from 3 percent to 6 percent by 1991.

Senator SARBANES. For everybody?

Secretary **Brady**. For everybody that qualifies for deposit insurance.

Senator **Sarbanes**. How about for those—your plan is going to allow some, as I understand it, to engage in more diversified and more risky activities, is that correct?

Secretary **Brady**. That is correct.

Senator **Sarbanes**. Do you require higher capital from them?

Secretary **Brady**. That is correct.

Senator **Sarbanes**. How much higher?

Secretary **Brady**. The capital will be pegged at 6 percent and, although these regulations are not finalized yet, the amount of capital they will have to have, as I mentioned, is 6 percent. If you buy a government bond, then you only have to use a small amount of capital. If you buy something more risky than that, you have to use a lot more capital.

So the capital is the controlling mechanism. It is more or less the same kind of system that is used in the securities industry. The more risky the investment, the more of your capital you have to use. At some point in time, you have gone over the line. You have used more capital than you can, and you can't take any more risky investments. It is chopped off right there. You have to sell something risky and go back into something less risky, or put more capital into your savings and loan.

Senator **Sarbanes**. That institution is more exposed than an institution that is not engaged in those activities, is it not?

Secretary **Brady**. That would be correct.

Senator **Sarbanes**. Why should that be allowed to happen?

One of the problems here that we are hearing about—and it is a reasonable problem—is the well-managed, sort of conservative, careful institution comes in and they say, we didn't contribute to this problem, we ran a good institution, we did the traditional activities, we turn a reasonable profit, and we perform an important public function. We are now being dragged into this by these high fliers.

Even by your own testimony here this morning, as I understand it, the negative aspects are fairly highly concentrated in terms of the number of institutions, yet they are pulling all these other institutions down with them, and now these other institutions under the circumstances, with very little alternative, are going to have to pay up more, their premiums are going to go up, and so forth, and so on.

Now, there is some rationale for doing that. One of the things I wanted to ask is, is there anything in here that is going to provide some incentive to get the industry to police itself so they don't simply look the other way while someone is engaged in all of these high flier activities and then comes home to involve everyone?

But why shouldn't there be some way to structure it so that if—first of all, I have some question how far outside a reasonable range of activities there should be any permission if you are going to have the insurance. What you have is people get the money in, and it is guaranteed by the Government. We are in here now coughing up literally $100 billion, one way or another, to cover this. These people then take money—they are not risking their own money, or very little of it—and it seems to me one of the thoughts that ought to be given is to really require them to put a lot more capital in to begin with so you have a line of defense before you even reach the deposit insurance.

It seems to me you have got to think somehow of constructing more of a buffer, so that if an institution—it may even be poorly managed. It may be no worse than that. I mean, that is not what we have seen, but it may be no worse than that, but a lot of that gets absorbed out of the capital they have put up front before you ever reach the deposit insurance.

Secretary **Brady**. Well, you put your finger exactly on the right point. The greatest form of regulation you could find is the fact that you are going to lose your own money first.

That is the central piece of this plan. We are requiring, if the Congress goes along, capital in the industry to be raised from 3 to 6 percent. So if the fellow running an S&L makes a mistake and takes too big a chance, he loses his money first.

In our opinion that is a very powerful incentive for him not to take that chance.

Second, you have raised the question of outside activities. Why should they be allowed? Why should savings and loans be allowed to do any activities at all, outside the financing of home mortgages?

In the late 1970's we found that because of the action of the free market, savings and loans were borrowing funds at 9 percent and lending them out at 8 percent. Over time, that will obviously produce a loss.

So we decided to give thrifts a chance to put their money into something, so that if they borrow money at 9 percent, they can earn a 9.5 percent return.

So I think what you have to do, Senator Sarbanes, is balance the system a little. Don't restrict it just to home mortgages because we know that will get S&L's in trouble.

But make the capital requirements very painful; i.e., they lose their own money first, and they will leave these other activities.

You also raised another point which I think is significant. What about the good people in this industry who have stuck to their knitting? Why should they be required to pay?

Well, that is an age old question. It has been visited on a lot of different industries.

But I will say this. There is a bonus in this for everybody, which is once the system gets in place the interest costs for savings and loans will fall. You can imagine people, even in spite of the Federal guarantee, requiring a higher interest rate today when they read every day in the newspaper that there is a $90 billion problem in the fund.

They think well, I know the Federal Government is there but these fellows aren't running things very well, and I am not going to lend at 9, I want 9.5 percent.

I think once a plan like the one we are talking about this morning is in place their interest costs will come down. We are almost positive that that will happen.

Senator **Sarbanes**. Mr. Chairman, I think my time is up, but I want to ask one very quick question.

If it weren't for the practical problems associated with the situation where you are in going from 3 to 6 percent and the problems connected with that in terms of an additional burden, but simply looking at it in the abstract, do you think the figure should be even higher in terms of the amount of capital cushion for these institutions?

Secretary BRADY. Well, it is hard to pick an exact figure. What we are doing is bringing them up to the level required for banks. I think as a starter that will be a figure that will provide the protection that we want and yet not impose a requirement for capital so hard that the good ones will be driven out of business.

The CHAIRMAN. Thank you very much. We will pursue that line of questioning later.

Senator Heinz.

Senator HEINZ. Mr. Chairman, first I have a very brief follow-up on Senator Sarbanes' line of questioning.

Under the President's plan, the FDIC will be able to restrict risky activities that have been authorized by some States in the past. That, of course, is permissive authority to stop the State authorized activities. Will this authority be applied to banks as well as S&L's?

Secretary BRADY. Well, the FDIC has its own regulations that apply to the banking system and they will continue.

Senator HEINZ. So it will be different from S&L's than for banks?

Secretary BRADY. The powers that S&L's have are different from banks.

Senator HEINZ. At this point which, if any, State chartered powers for S&L's would you recommend be stopped?

Secretary BRADY. Excuse me, Senator?

Senator HEINZ. Which, if any, powers now granted by States to S&L's would be stopped?

Secretary BRADY. I don't have a precise litany of all the powers that would be restricted, but we have seen all kinds of outlandish investments—herds of prized cattle, dirt loans, so-called, investing in open fields—that I think should be throttled back. That is what the new regulations are attempting to do.

Senator HEINZ. I assume we are all saving the adequacy of funding questions for last, which is a big question.

One issue that impacts, I think, on whether the plan will be a whole cloth is what will be the future of the thrift industry. You proposed a series of very tough and welcome reforms. If the reforms are too tough, of course, and they drive the industry out of business and it will be very costly for the Federal Home Loan Bank System. In addition the revenues that we want and expect to get from the healthy S&L's under the President's plan will not be there.

So my question to you is this. In your testimony on pages 3 and 4, you note that reregulation of deposit interest rates coupled with the development of the secondary mortgage market has lowered the spreads and the profitability of the thrift industry.

Under your plan, thrifts will continue to pay high insurance premiums and will contribute 20 percent of the profits of the Federal Home Loan Banks in order to fund the cost of the resolution. At the same time they have got to meet those tough capital standards in just 2 years, by June 1991.

Your testimony, also on page 9, states that at present less than half of all thrifts meet current bank capital requirements.

ALL THRIFTS MAY NOT MEET THE 1991 DEADLINE

Based on the current spreads in the industry and the higher costs imposed on thrifts under this plan, how many thrifts do you estimate will fail to meet the new capital standards deadline in 1991?

As background, there are about 3,000 thrifts. About 1,800 thrifts currently are under 6 percent, and about 720 thrifts have been or will be resolved under your plan.

This will leave about 1,100 thrifts that you don't plan on resolving that do not now meet the capital requirements.

Of the roughly 1,100 thrifts that do not meet the capital requirements right now, what proportion of them and how many of them will not meet the higher capital standards by 1991?

Secretary BRADY. I can't give you that figure exactly, except to tell you that it has been factored into the stream of funds that we estimated are needed. I could get the figure for you.

Senator HEINZ. I would appreciate that. It seems to me that is a fairly critical issue.

Secretary BRADY. Yes it is.

Senator HEINZ. Let me go ahead while research is being done.

On the first page of your testimony you used the phrase "never again" five times. I commend you for it. That phrase of course really was a reaction to the holocaust. It is the theme of Soviet Jewry, and it is not inappropriate here because this is a financial holocaust and it is the taxpayer that is getting burned.

Some people, though, who have looked at the plan have said that the estimates that you have come up with are never enough. I have learned over the last year, if I have learned anything, not to get too attached to anybody's estimate of the size of this problem. It seems always to go up. Every time you think you have got it pinned down, it escalates some more.

So to borrow a phrase from a well-known context, I would say dovere no provere, which is a Russian expression for trust, but verify.

Let me just ask you a couple of quick questions or ask you one quick question.

With respect to the 222 cases resolved by the FSLIC in 1988 which rely heavily on the use of yield maintenance and capital loss agreements, has the Treasury examined these deals and verified the estimated costs to be $40 billion?

Secretary BRADY. Senator, we have not. As you know, all of these deals were done by the FSLIC, and we are hoping to have those figures submitted to us. But we don't know the answer to that question at this time.

Senator HEINZ. And I assume that the 500 insolvent thrifts, you have the same estimating problem there?

Secretary **Brady**. You mean the ones to be done in the future? Well, no. We certainly have asked the FSLIC what their experience costs were, and we made our own estimates.

The reason why some of the estimates that you have seen of the size of the problem are greater than the $90 billion that we came up with is that they take the experience cost of the worst cases. When you are losing 40, 50, 60 percent of your assets, and apply that to all the remaining thrifts that need to be resolved, of course the estimated resolution costs vary.

Our estimate starts out, as I mentioned in my testimony, with a gap on their books for these 500 institutions of about $18 billion. That is just what the books say. Then you say, all right, I am going to do something about that, and you take the assets and begin liquidating the institution—as opposed to merging it. You have some assets on your hands which you have to sell, which you probably can't get market value for. So we say, now, we have got to look at this group of assets to see what we can estimate will be actual costs at which they sell.

That is where our figure gets up to around $40 billion for past resolutions, $40 billion later, for a total of about $80 billion, and some $10 billion of leeway, Senator Heinz.

Senator **Heinz**. Mr. Chairman, my time has expired, but I would just like to make a short observation.

The **Chairman**. Please do.

Senator **Heinz**. Secretary Brady has made the point that they have relied in the first case on FSLIC estimates on these 500 thrifts and then has adjusted them. My problem is that garbage in is always garbage out. The FSLIC estimates have proven terribly unreliable in the past. I fear this is the case with respect to the 500 future cases to be resolved for this reason.

If you look at what the negative net worth of those institutions is now, it is roughly $20 billion. You are saying it is going to cost $40 billion. So that means the estimate of loss on the assets can only be about another $20 billion of the resolution cost. You are talking about a base of assets in those 500 institutions that is $265 billion. That means that you are only allowing for an 8.3 percent shrinkage of assets from book value to market value.

If there is one thing we have seen in these troubled institutions, the market value of their assets has been 20, 30, or 40 percent less than what is estimated on their books. Therefore, I worry—I am not saying you are wrong, but I worry that it is very tough for you to be right.

Secretary **Brady**. Can I respond, Mr. Chairman?

The **Chairman**. Please do.

Secretary **Brady**. First of all, Senator Heinz, we examined the FSLIC estimates as you would and tried to assemble every piece of evidence as to what should be the actual resolution costs to apply to these assets. That is one of the things we looked at. We watched, to the extent we could get figures, how they were doing. We have made our own 2- or 3-month study in the Treasury, trying to assess exactly how the future might play out with respect to the resolution of future S&L's in trouble.

I am not sure I am looking at the same figures you are, but with regard to the $50 billion, there is $40 billion gone behind us now that has been done through 1988. In the future we say the size of the problem is $50 billion. We also say that if you take the 500 institutions that I think you were referring to, that they have a negative net worth of $18 billion. So you say $18 billion, you have got $50 billion to use to resolve that problem, that is pretty good.

We say, no, wait a minute now, that is not the case because that is just what the hole is between their liabilities and their assets. When you actually liquidate those institutions, you have got the assets inside or will have the assets inside the Resolution Trust Corporation. Now, you have got to go out and sell them to somebody else, not the next morning because you don't want, as Senator Gramm, I believe, mentioned, to go out and depress the market, which selling them would. But you have got to go out and sell those assets and raise the money in order to pay off the deposits.

We figure that probably you are going to have to spend another $20 billion in order to get those assets—you probably will suffer another $20 billion diminution in order to get those assets sold.

So I think we have been pretty conservative. I don't know if it equates out to the 8-percent figure. We have got to check and see whether we are talking about the same thing, but I think we have left a very, very sufficient cushion there to do the job.

The **CHAIRMAN**. If I may just say, this is a very important line of questioning, and I know others share the concerns that Senator Heinz has expressed here. These are complicated calculations, and they involve a whole series of assumptions, and depending upon those assumptions, the numbers can get much larger than what we are talking about.

I think there is a general uneasiness about that part of the plan until we have had a chance to really work this over very carefully, which we of course intend to do. But that is an issue we will continue to discuss.

Let me now call on Senator Graham of Florida.

Senator **GRAHAM**. Thank you, Mr. Chairman.

There is an assumption behind this proposal that there is a public purpose to be served by the continuation of the thrift industry. On page 12 of your statement, there is a sentence that "Nevertheless, problems in the S&L industry are a threat to the viability of our housing finance system."

There is a counter position that the S&L industry has outlived its usefulness, and whatever purpose was justifiable in the 1930's has now been superseded.

Can you give the basis of your belief that there is a social value to be served by an independent thrift industry?

BASIS FOR AN INDEPENDENT THRIFT INDUSTRY

Secretary **BRADY**. Yes, Senator Graham. To me a case can be rather simply made. The S&L industry estimates do vary, but now it holds about 40 percent of the home mortgages in the United States. That is a very, very important part of people being able to finance new homes and old homes.

So I don't think you have to go too much past that point to decide that this is an industry that counts, is doing the job, and should be put on a sound footing. Of course, putting it on a sound footing is what we are all talking about here this morning.

Senator GRAHAM. And your assumption is that if there were no independent thrift industry that there would be a reduced access to funds or housing or a higher cost to funds or housing?

Secretary BRADY. I think so. I presume that if 40 percent of the mortgages are orginated by the S&L industry the home buyers of this country are pretty smart people and they are going to a place where they can get the best service and lowest interest rates.

So I think by removing that part of the industry you have removed something that is very important to the people of this country who are trying to finance homes.

Senator GRAHAM. To follow on the questions that Senator Heinz was asking, I have been concerned about the sliding institutions—I think in your testimony you used the word "marginal"—and what steps can be taken now to try to avoid those institutions falling into insolvency.

I was concerned last week while I was visiting a medium sized city in my State to see that an institution which is insolvent was aggressively advertising for deposits at rates that were a point and a half above what other institutions in the area were paying.

Does the Treasury have any recommendations of what might be done, either administratively or congressionally, to attempt to save these marginal institutions?

Secretary BRADY. Well, I don't want to be flip, Senator Graham. I would say solve this problem as quick as we can. Give us the money. I shouldn't say "us." Give the Resolution Trust Corporation and the FDIC the funds. Fund the plan that we have put forward, either this one or a slight variation of it, and you will see that those institutions which are insolvent will be dealt with. They will be brought into the Resolution Trust Corporation, and they won't be out there bidding up the funds.

Senator GRAHAM. Some of the things that are of concern to me is that there seems to be a preference for solving the problems by encouraging these weaker institutions to grow out of their difficulties. The fact that your plan is predicated on a 7-percent annual growth in deposits in the thrift industry seems to indicate that that will be a continuing strategy. That in turn has been fueled by the extensive use of brokered deposits and the type of aggressive pursuit of funds that this one institution engaged in.

Are these not some areas in which steps could be taken administratively even before the Congress has acted on your plan?

Secretary BRADY. As I am sure you are aware, the day after the President made his speech, the insurance function of FSLIC was deeded over to the FDIC. Since that time they have taken control of just under 50 institutions and of the insolvency that was inside those institutions.

I would say to one of your former concerns that the raising of the capital ratio from 3 to 6 percent—where we ask these institutions to put their own money up first ahead of the Federal guarantees—is going to change the way these institutions operate. They are going to have to use their own money. They may be able to go out and raise federally insured deposits, but they are going to have to put their own money out there first.

Senator GRAHAM. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Graham.

It seems to me, just before passing the ball to Senator Bond, that that relates to their ability to attract capital. It depends in a sense on their operating charter. We talked about that earlier. If we are going to use housing as a centerpiece, what are the wrap-arounds?

I think we really have to focus on that question and not leave it up in the air because it impinges on every critical aspect of the workout plan.

Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

Mr. Secretary, you emphasized several times that the increase in premiums paid by the commercial banks are not going to be used for the savings and loan industry. I can assure you however, that there are quite a few bankers I have run into in my own State and elsewhere who are somewhat skeptical.

Are you going to propose any specific statutory language to assure that the money is used only by the industry's FDIC fund?

Secretary BRADY. I believe that language is in the law submitted to you this morning.

Senator BOND. And you feel that is adequate to assure that?

Secretary BRADY. We do.

ALLOWING BANK HOLDING COMPANIES TO BUY FAILED THRIFTS

Senator BOND. You have proposed allowing bank holding companies to buy failed thrifts and not be burdened with cross-marketing restrictions and tandem operation restrictions. After 2 years bank holding companies could buy healthy thrifts without these restrictions.

Our banking laws are a crazy quilt of exemptions and grandfathering, and I wonder what your view would be—wouldn't this exemption just muddy the waters further? Should we just repeal these restrictions across the board?

Secretary BRADY. I think, you know, that this way of allowing commercial banks to enter the savings and loan industry is one that does two things.

One, it is fair to the S&L's. It gives them time to work these problems out, but it also addresses the problem of how we are going to get capital into this industry. That is a problem that needs to be addressed.

Senator BOND. I know several of my colleagues have touched on this before, but the one concern that I have had in talking with people who are knowledgeable about the industry in my State is the feasibility of 2 years to reach the 6 percent capital standard.

We are very fortunate in Missouri that a significant number now meet that 6 percent standard. There are quite a few in the 3 to 6 percent range which perhaps could make it. There is concern that 2 years is too short, that people who are in the industry prefer 5 years.

I would appreciate your views on just how quickly you think we can reach that standard without unnecessarily torpedoing thrifts which are healthy now and would need some time to accumulate the initial capital.

Secretary **Brady**. Senator Bond, I agree that this could be looked on as a problem by some in the industry. However, I would also point out that of the 2,952 S&L's that we have in this country, some 1,239 are already over the 6 percent capital requirement. So that is a pretty good start, and there are another 972 which are between 3 and 6 percent. So they have a pretty good running shot at getting up to the 6 percent level.

I don't minimize the problem of trying to get capital into the industry, but I think that if we put this plan into action you will see the cost of funds come down for S&L's because you have got a sound industry. I think that capital can be contributed into it.

When I was in the securities industry, we had to go through a couple of reforms more than once, some of which were voted on right here in this committee room. I don't remember ever liking them too much because they always increased the amount of money you had to put up.

The biggest fight we had in the securities industry, I am sure some of you remember, was over the end of the fixed commission. The industry was absolutely convinced that if you ended the fixed commission the whole securities industry was going to go broke.

Well, that didn't last too long. I think last year the profits of the industry were five to six times what they were back then.

So I hear what the industry is saying, and I think they have some good points to make, but having been in this position myself, I lay great stock in American ingenuity to battle on and go forward. If we have a service that needs to be taken care of for the provision of home mortgages and you have people who have money to put up and a Federal guarantee to provide you funds, I think that is a pretty good deal.

Senator **Bond**. No one has ever accused us of having pleasant solutions to this problem, I realize. I am concerned about 2 years being a relatively short timeframe. That is the only thing I had.

Secretary **Brady**. I think you have got a good point, and your concern is one that we have heard raised any number of times, Senator Bond. The other side of the argument is—and I don't want to be tough-minded—we have a $90 billion problem now. The capital requirements that we came up with for the industry were ones we thought they could meet and still be sure that we don't have a $90 billion plus problem somewhere further down the road.

Senator **Bond**. Thank you, Mr. Secretary.

The **Chairman**. Senator Bond, I share your concern in that area because one of the issues here— not to trespass on the time of Senator Sanford, whom we will call on in a moment here—is that if somebody doesn't make it in that interim period, they can't climb up to the right capital standard. In effect, they have to go through a dissolution or an unwinding, and it is not exactly clear that some of those folks are going to fall back into a situation where public money may very well have to be used. So, it is not exactly clear that the ones that don't make it in the interim period don't end up costing more public money.

That has to be built into the estimates. I sense you have a concern about that possibility, and I know I do.

Senator **Bond**. That is my concern, Mr. Chairman. If they are building capital, there ought to be some provision to say that a savings and loan has got 3.5 percent this year and it can get up to 4.5 next year and 5 percent the next year. We ought not to toss them, we ought not to perform triage and put them in the dead category. We ought to have some provision allowing them to continue progress towards those capital standards.

I agree, the capital standards are one of the solutions, but let's don't make it so onerous that we create dead bodies out of reasonably healthy bodies.

The CHAIRMAN. I think if you were to require the fold-up of those institutions who don't make the standard, you may very well not recover what the stated book value is when you go in to do the liquidation. In other words, you are throwing more assets presumably into the pool to have to be worked out over a period of time, and you may, in fact, trade a manageable problem for a far worse, unmanageable problem that has got a bigger price tag.

I think that is one of the issues that we have got to sand down as we go to make sure that we are not working against ourselves.

Senator Sanford.

Senator SANFORD. Thank you very much.

I expect that if Missouri and North Carolina work together we might get our amendment worked out.

The question I would like to ask, Mr. Secretary, is how much less expensive would it be for the Treasury itself to sell the thrift rescue bonds instead of going through this roundabout way that has been designed to finance the bonds, assuming we can take it off of Gramm-Rudman if we want to?

SALE OF THRIFT RESCUE BONDS

Secretary BRADY. Senator Sanford, our estimate has been that these bonds will sell at a premium to Treasury bonds of about 25 basis points.

Senator SANFORD. Suppose they don't.

Secretary BRADY. Then it will be 30 or 35 or 50.

Senator SANFORD. I was going to ask if we would more likely end up at 45 or so basis points over Treasury bonds.

Secretary BRADY. Well, I am just giving you our estimate.

Senator SANFORD. Why don't we do it in the cheapest way through direct Treasury borrowing?

Secretary BRADY. I think we are doing it in the cheapest way.

Let me point out to you that although these bonds will sell at a premium to Treasury bonds, we also have industry funds going in to pay part of the interest, some $300 million worth of industry funds per year. If you would make the calculation with me, $300 million divided by the $50 billion in bonds that are outstanding is 60 basis points. So in effect, our plan is asking the industry to contribute 60 basis points to this problem.

Senator SANFORD. That is quite true. The only problem there—and that is part of the whole picture of how much of a burden can we put on the thrift institutions—that the $300 million from the Federal Home Loan banks essentially would be dividends back to the thrifts were it not diverted to this. That in turn makes it even more difficult for them to come up with the proper capital requirements.

Secretary **Brady**. Senator, I understand that, but the central problem of coming up with this legislation was one of cutting the baby in half. How much do you visit on the industry in which some wonderful people labor every day but also others who have not done so well? How much do you ask the taxpayers to pay?

Senator **Sanford**. I am concerned that it was primarily the regulators, the agents of the taxpayers, that caused all this trouble, and that placing an undue burden on the healthy thrifts will only cause more to fail, placing an even greater burden on taxpayers.

Secretary **Brady**. Well, I don't want to debate that with you, but there is plenty of blame to go everywhere. The problem that we had to face—and now it is in your hands—is who pays how much? In other words, how much does the industry pay and how much do the taxpayers pay?

Senator **Sanford**. I appreciate that, and I don't want to hurry along, but my time it running short.

I'd like to turn to the issue of brokered deposits. We have read stories of institutions consisting of little more than a post office box and an appeal for brokeraged deposits, in essence providing access to federal deposit insurance to Wall Street brokerage houses and large-scale investors. Such deposits have added liquidity perhaps, but they have also brought on a great many problems and bad practices.

It certainly wasn't the intent in the beginning to provide that kind of protection. We really began by starting out to encourage small-scale savings for home loans.

Do you see any need to regulate further to get back to some of the basic purposes of saving and to stop the devices that use this for purposes not intended?

Secretary **Brady**. Senator, you have put your finger on the right point. A great part of the increased regulation that we are suggesting here is aimed just exactly at that—to try and stop the practices that you have outlined.

Senator **Sanford**. Thank you. I do take a great deal of encouragement from the fact that you have asserted two or three times that it is the public policy of this administration to support this thrift industry and to have it continue to the extent that it can.

Secretary **Brady**. That is our intent.

Senator **Sanford**. Are we doing anything to make it easier or more difficult for those thrifts that want to become banks to both escape and get in the FDIC, or escape from the FSLIC?

Secretary **Brady**. I am glad you brought that up. In the proposed law we have a provision whereby we put another 5-year moratorium on savings and loans becoming members of the FDIC until we solve this problem.

Senator **Sanford**. Has there been any determination made about what the logo would be when there is a new insurance agent for the savings institutions?

Secretary **Brady**. I don't believe so, sir. No, if I understand your question.

Senator **Sanford**. Thank you very much.

The **Chairman**. I know that is a sensitive subject, and it is an important question. It is the first time it has come up. It has got to be resolved one way or the other.

Secretary **Brady**. Would you say it again? Perhaps I didn't hear what you said.

Senator **Sanford**. The logo, the FDIC logo or sticker.

Secretary **Brady**. As Senator Riegle says, this is a hot item, and there has been a lot of discussion. We have taken points of view from both the banks and the S&L industry. As you can imagine, the banks would like to have their own logo. The S&L's feel that this fund will be reconstituted and they are entitled to a sticker that is the same as the banks.

So I imagine somehow in this process, Senator, we will come out with the answer to that question. Maybe one logo with different language underneath it.

The **Chairman**. I gather the answer is that you are still looking at that question and that is not settled as such in your own mind. The administration therefore is not proposing an answer yet on that question?

Secretary **Brady**. That is correct.

The **Chairman**. Thank you.

Senator **Sanford**. Thank you very much.

The **Chairman**. Senator Kassebaum.

Senator **Kassebaum**. Mr. Secretary, Senator Sanford mentioned brokered deposits briefly. I have long been interested in the role of brokered deposits on the stability of financial institutions.

Talking about assumptions, one of the key assumptions made in the administration's plan is for a reduction of the cost of funds to the thrift and banking institutions.

As you are, I am sure, familiar, in 1984 both the FDIC and the Federal Home Loan Bank Board proposed a rule to restrict the Federal deposit insurance to $100,000 per brokered deposit. Absent enactment of such restrictions, the regulators predicted significant increases in the cost of funds and substantial transfers of insured deposits into unhealthy institutions. Left unchecked, the regulators predicted brokered deposits would ultimately threaten the insurance funds and result in higher premiums.

It seems to me that their predictions have come to pass, and I wonder—even though there have been assurances that the brokered deposits are under control, there are certainly still those who suggest that it could be a problem, and I wonder if you looked at the 1984 proposed rule.

BROKERED DEPOSITS

Secretary **Brady**. Senator Kassebaum, the idea that you might be able to restrict the $100,000 deposits is one that we have looked at. The advent of the computer has added greatly to the inability to track that kind of thing. There is a great body of money in this country that seeks the protection of deposit insurance, and it is pretty quick to compare rates everywhere. That is all done by computers, to a large extent.

So if you broke the thing down and said you can only have one deposit of $100,000, I am afraid everybody would start breaking them up into increments of $50,000 and $25,000 wherever you put the limit.

So you have very fast money transfer in this country and no computerized way of keeping track of things. It wouldn't be too hard for the guy who you said could only have one deposit over $10,000—or $100,000—to keep splitting it up so you couldn't keep track of it. We just don't know quite how it would work out.

Senator KASSEBAUM. Could you just not insure those accounts at all?

Secretary BRADY. If you could catch them, I think it would be fine. The question is in this day and age of computers it would be very hard to catch, I would think. That is our judgment.

Senator KASSEBAUM. I would like to go back a bit to Senator Bond's question on the tandem operation restrictions because you recommend that the banks could purchase healthy thrifts and operate them without the tandem operation restrictions.

In the past those restrictions have meant that, say, a bankholding company who purchased a thrift that had an insurance brokerage firm or a real estate development corporation would have to divest themselves of those operations.

Are you saying that would no longer be the case?

Secretary BRADY. During a 2-year period, it could only be waived in the case of a failing thrift. After that time a bank holding company could then buy a savings and loan.

Senator KASSEBAUM. But could buy a savings and loan and would not have to divest themselves?

Secretary BRADY. Excuse me. I amend that statement. They would have to divest the nonconforming activities after that period.

Senator KASSEBAUM. After the 2-year period they would have to divest?

Secretary BRADY. Yes.

Senator KASSEBAUM. I would like to ask about something else, and I just don't know if it's all that important. But in chart three in your testimony you show that there is a new bank insurance fund, at the bottom. The sources are increased commercial bank premiums that go into a new bank insurance fund.

Now, is that something—I am assuming that is something separate from the FDIC.

Secretary BRADY. I don't know as that is. It seems to me that that is the old bank insurance fund. You are very observant. Let's just cross out the word "new." I didn't expect you to be reading the notes on the bottom line. [Laughter.]

Senator KASSEBAUM. By the time it gets to my end of the line, you're looking for all sorts of details. [Laughter.]

But there is nothing mysterious about that, it's just the FDIC?

Secretary BRADY. No.

Senator KASSEBAUM. Thank you, Mr. Secretary.

The CHAIRMAN. Thank you, Senator Kassebaum.

Senator Bryan of Nevada?

Senator BRYAN. Thank you very much, Mr. Chairman.

Mr. Secretary, I thought your testimony in terms of a future role for the savings and loan industry in terms of home financing was a persuasive one.

But I am a little bit troubled by what I find to be an internal dichotomy in terms of the role and the scope of activities permitted by savings and loan and thrift institutions in this post-reform era that is contemplated by your legislation.

You have told us that those savings-and-loans that in effect pay attention to their knitting and stay close to that are, by and large, institutions which are not in this insolvent category. Those are actually the healthier category of savings and loans.

Then, in response to questions by some of the members of the committee, when asked should we delimit the scope of investment activities on the part of savings and loans to essentially home mortgages, you say no, we should not do that, we should allow them expanded activity.

Then you seemed to acknowledge some of that expanded activity has a considerably higher risk, and your suggestion is, well, there ought to be increased capitalization requirements that are proportional to the risk.

I guess what my question is: In light of the history that we have seen evolve over the past few years and the temptations that were present, how can we be assured if we permit that expanded investment option to the thrift industry, how can we be assured that they are going to retain what many of us believe to be their historic role, which many of us believe ought to be its primary function in the future?

How can we see this restricted to that if they are not going to get far afield by telling regulators we are prepared to increase our capitalization requirements to be permitted to be involved in this more risky activity?

Secretary **Brady**. Well, Senator Bryan, I think we are a little bit of a captive of history here. Going back in time to when S&L's were restricted to more tightly controlled lending practice, they were suffering from extreme diminution of profits. The borrowed funds they were raising were more costly than the returns which they were receiving in the form of mortgages. So, the Congress and the administration expanded the powers which would allow them to invest in different activities. Then we found they went too far that way, particularly if you have always on the other side the specter of having to make good on the deposits, which are good in the past, good today, and will be good in the future.

All I can say to you is it's a narrow road. What we have tried to do here is by increasing the capital requirements, to use a good old business principle which is if you make somebody put more of their own money into the pot, they're going to be much more careful about how they invest it. That's No. 1.

No. 2, the new regulations under which the FDIC will be issuing insurance are going to be more closely watched and more closely monitored. The FDIC has the ability to go in and tell somebody to stop doing something. They will be monitoring the capital requirements and we are hoping that is the road we can go down.

Senator **Bryan**. Mr. Secretary, to make sure that the industry performs its function as contemplated, I think, by your testimony, and certainly by many of us in the Congress, should we require some percentage of the portfolio that must be dedicated to mortgage financing?

REQUIRE A PERCENTAGE OF FUNDS FOR MORTGAGE FINANCING

Secretary **Brady**. I am not exactly sure how the final i-dotting and t-crossing of those regulations has turned out in the law that has been discussed during the last weeks. But by grading the capital needed for each of these specific functions, you are going to be in effect doing what you say. By the amount that you set a lower requirement for something safe like home mortgages, you will be able to do more of that activity. So the person running an S&L will do just exactly that.

Senator **Bryan**. I take it from your answer that you don't feel it's necessary to incorporate either by legislation or by promulgated rule a percentage of the portfolio that would be allocated to home mortgages? You are content to let the free market, I gather——

Secretary **Brady**. I think the system that we have in the law we submitted to you will work, Senator Bryan.

Senator **Bryan**. Finally, my question in response to the cost and the cheapest way to do this. You have indicated that the plan which the administration has advanced is the cheapest—to use your testimony—that is available, I presume, among the alternative that have been discussed.

We have had some testimony before this committee, there has been considerable colloquy by members of the committee with witnesses who have appeared, and there has been considerable commentary generally in the financial press that it would be far cheaper to simply directly finance this through the Treasury.

Do I understand your answer to be that that would not be cheaper? And if it's not your answer, then how much, if we could quantify using the numbers that you provide us—$50 billion for step one, second, $40 billion, and third for $33 billion, those numbers being taken from page 13 of your testimony—what is the cost differential to the American taxpayer?

Secretary **Brady**. I will answer your question in several parts. If you say how much extra does the fact that the REFCORP bonds are financed off-budget, how much extra is that going to cost, we say our estimate is about 25 basis points a year. Maybe it's 30. We don't know exactly.

Senator **Bryan**. Assuming that is a safe mark—and I realize my time is up—what is the total cost?

Secretary **Brady**. I could get you that figure. I don't have that number.

But please let me answer the other part of the question. Also implicit in the REFCORP financing plan is the use of $300 million per year of savings and loan industry money that you apply to the interest. So, if you take that $300 million and divide it by $50 billion, you will come out with the fact that 60 basis points are being provided by the industry, not by the taxpayers.

So that to the extent that the REFCORP financing plan is under 60 basis points, it's our feeling that it is cheaper for the taxpayer and also brings the S&L industry into the solution of the problem.

Senator **Bryan**. My time is up.

The CHAIRMAN. It's a very important issue. I am next in order here, and I want to pursue what you are inquiring about because, no disrespect intended, I don't think that is a clear answer.

And I would like to ask—I know you have got some of your people with you today—if you could, to do a calculation and have it available in a couple of minutes on what that 25 basis points premium that you were citing a minute ago converts to in total dollars. I assume in billions of dollars over some time period. Maybe it's less than that.

In any event, I think if that is your sense of the spread, 25 basis points—did I hear that right, by the way?

I think we ought to have a quick calculation so that there is some sense of the range of the premium cost. Then, if you find that you want to refine that later, we will go ahead and make that refinement. But it shouldn't be that hard to do a 25-basis-point calculation on the numbers.

Secretary BRADY. The answer, Senator Riegle, is $125 million per year.

And the other figure that I answered Senator Bryan with is that the industry is putting in $300 million a year.

So, both of those gross figures are ones that should be looked at.

Could I just correct one answer that I gave you before? To be a qualified thrift lender—and this is also Senator Bryan's question—which is a term that we do incorporate in the bill—an S&L has to have 60 percent of its assets in housing-related finance. That lending may not be solely home mortgages.

Senator BRYAN. Sure.

The CHAIRMAN. Now let me go back to the estimate that was just done at the table, $125 million a year. That is for how many years?

Secretary BRADY. That's 30 years. It comes out to $3.75 billion. And the 60 basis points that the industry is contributing is nine-point-something billion.

The CHAIRMAN. I think that is an important secondary point, that they are going to contribute that anyway. The question is are we requiring the taxpayers to have to pay the premium for the part of this that has got to be financed? Might we save that money if we were to finance directly?

Secretary BRADY. Well, if you want to do what we did—which we thought it was the best way to do it, Senator Riegle—you ask the industry to put up the $50 billion that is necessary for financing REFCORP—we think that is the best way to do it—and suggest that REFCORP go out and buy zero-coupon bonds which mature on the same schedule as does the requirements to pay off those bonds.

You know, I don't want to polarize the issue, but if it is the thought that we should put the burden on the taxpayers and therefore impede the budget with one less Trident submarine or day care center or whatever it is, that's another way to do it.

But again going back to what we were trying to do, which is cut the baby in half, we feel this is the fairest way to do it.

The CHAIRMAN. Am I correct in thinking that the figure you have given me just covers the REFCORP bonds and if we were to include also the FICO bonds, that there would be another premium charge that we would have to calculate here? Wouldn't there be roughly another $71 million a year if we include the FICO bonds as well?

Secretary BRADY. Again, to the extent that you use FICO bonds—I think the suggestion is that we use about $6 billion of those—there would be an additional charge.

The CHAIRMAN. That would be $71 million a year, apparently, again over the 30 years?

Secretary BRADY. $70 million a year, currently.

The CHAIRMAN. For 30 years. So, we are talking then, we are looking at about $3.75 billion in cash over the 30-year period of time. Now, obviously you can bring that back to present value, but that all is going to have to be paid.

I think one of the questions that I have heard a number of members ask and is in my mind is: Is there really a justification for sort of doing kind of the sidedoor financing, if you will, and paying the basis point premium?

We are, in a sense, getting around the budget. We are really using that as a way to get around the Gramm-Rudman-Hollings discipline. If we didn't have that in effect, you say, well, if you're going to do it direct through the Treasury, you could do it for less.

But under the budget discipline, then, you've got to take it out of some other program. Well, that is if we define it that way. We are not compelled to do it that way if we thought that was an unwise way to do it.

It seems to me one of the burdens that the plan carries is to explain why it is that nearly $4 billion in premium costs over 30 years ought to get put in on top of this in order to sort of do a little sidestep on the financing issue.

Secretary BRADY. Senator, I don't think it's exactly a sidestep. What we were trying to do is bring the industry into this in the best way that we could. And what we did in order to do that was devise a plan which, as we have described, involves buying zero-coupon Treasuries. The industry funds the $50 billion.

If there is some other way to get the industry involved to that extent, we would be glad to look at that. But that is the way we were able to run it, not as a way to get around the budget but as a way to apportion the cost of coming up with the $90 billion.

The CHAIRMAN. You and I are in agreement on the idea that we have to wring every last dollar that we can out of the industry without destroying it and maintaining its viability.

But once we have reached that point, the question of how we raise and finance the public portion the financing mechanism becomes important because if you do it directly you can do it for less. If you find that you're doing it indirectly, you pay a premium for that.

You know, I have to tell you that I haven't heard the argument today or before today as to what really justifies that premium. Why should we lay that extra cost on top of the underlying cost of the solution?

We may have to continue to discuss that outside of this hearing room because I don't want to trespass further on the time of Senator Garn.

But I don't think we yet have an answer on the record that holds up.

Secretary **Brady**. We can try to provide you some information on that, Senator Riegle, if that would be helpful.

But I do think that the answer lies in trying to get as much participation out of the industry as we can. If at the same time it costs 25 basis points more to finance it this way to get the 60 basis points out of the industry, that was one of our aims.

The **Chairman**. I am not sure the two depend one upon the other. It seems to me that you can still extract as much as you conceivably can from the industry and then finance the public portion the most direct route and at the lowest cost. That really was my question.

Senator Garn?

Senator **Garn**. Thank you, Mr. Chairman.

Mr. Secretary, we have all heard a great deal of talk about how the regulatory structure is failing. There is no doubt that that has been part of this problem.

I think many times lost in that argument, however, is the fact that the regulatory structure over the last 2 to 3 years has been improved. The Federal Home Loan Bank Board was able to get out from under Gramm-Rudman-Hollings and the caps and hire more regulators, more examiners, and pay them more so they could retain them and keep up with some of the smart CPA's out in the industry. And there have been a lot of changes in the last couple of years.

Chairman Riegle and I led the fight last year in the CEBA legislation to exempt bank and thrift regulators from Gramm-Rudman-Hollings. And we won. But the OMB in the last administration fought us every single step of the way.

KEEP EXEMPTION FOR BANK AND THRIFT REGULATORS

So, one of my primary concerns again of putting the Federal Home Loan Bank Board under the Treasury is that those pay caps stay off. I am told that that is the case.

However, I am seeing games played. I see it down at the Comptroller's. If they classify Bank Board employees as Senior Executive Service, then the caps are back on. Most of the senior people down there are SES. Therefore, they are under the caps.

I think it is highly important that we make sure in this legislation that we keep all the regulators out from under the pay caps and restraints placed in the civil service system, or we are going to be back in the same box we were in 1980, 1981, 1982, and 1983, with people that you can't retain—that talent that you need in this very complicated area to be able to enforce the new regulations and the new policies that we are putting into effect.

So, I want to make that point very strongly. I have been assured over and over again that this will be the case. But I would like that assurance publicly—to make sure there are no games played down in the Treasury, that we are going to play games with SES versus civil service—so that we can retain the high-caliber people necessary to solve this problem and properly regulate the industry.

Secretary **Brady**. I would hope that would be the case.

Senator **Garn**. Well, do we hope?

Secretary **Brady**. Senator Garn, you have raised the arguments on the other side of the question as to where this shall report.

I can only tell you, first of all, that with regard to the Office of the Comptroller of the Currency, we don't micromanage the Office of the Comptroller of the Currency. It's in a different building. He runs his own organization and has a great deal of latitude.

But there is oversight by the Treasury. That is the kind of system that we are suggesting here, not a heavy-handed, invasive kind of approach. And we are not looking for more things to do at the Treasury.

We simply thought that with a heavy injection of taxpayer funds in here, there ought to be a direct connection back to the Government. That's the point we had.

Senator **Garn**. I understand this is a side point because Chairman Riegle and I really had a difficult fight with OMB over this very issue, the issue of apportioning.

It simply made no sense to us, and still does not. I am sure the chairman can speak for himself, and I am certain he has not changed his mind over the last year. We can't afford that kind of fight with OMB or with Treasury again and have the limitations of a Gramm-Rudman-Hollings placed on the funds—which first of all are not taxpayers' funds, they are premiums, and second that would inhibit hiring the caliber of people we feel are necessary to get, not only more quality but more quantity of people into these institutions.

As you look back at the regulatory problems, a lot of the things that happened and the reason some of the S&L's got away with what they did, were because you simply did not have enough people to get around to them often enough to find out what they were doing. And in some cases they had great talent, and even when they were examined they were able to conceal the fraud and abuses that were going on.

I don't mean to beat a dead horse to death, but if I am not successful in keeping an independent agency, then I want to make certain that some of these other things within Treasury are abided by.

Secretary **Brady**. Well, I think again you stated very eloquently the point of view for not having it report to the Treasury but to the Fed or some place like that.

I can only tell you that when you get this kind of a problem, something like $90 billion, that we have got an awful lot of phone calls from Senators and Congressmen asking, what's going on.

We had no ability to call in the Chairman of the FSLIC and ask him directly what are you doing and why are you doing it?

For certain times and tides, that is a very good thing. For other times and tides, it's not a good thing.

Senator **Garn**. I understand your point of view. But the President certainly has the ability to call in the chairman of an independent agency—the SEC and others that work rather well.

Maybe I have been here too long, after 15 years, to see great plans passed by this body and administrations with good intent. I don't question your intent or the administration's. I am on board. I support the plan. I am in praise of it and of the administration moving forward.

But I have been around here long enough to see how it gets confused and how it doesn't work, and 2 or 3 years later we find out, hey, that was great legislation, but it's not been implemented in the manner that we expected.

I have been tremendously frustrated by seeing Secretaries of the Treasury come and go, Secretaries of Defense come and go, Presidents come and go; and new Presidents, new Secretaries of the Treasury are only minor irritations to the bureaucrats because they know they will still be there after two or three administrations come along, and things sort of go on as they have in the past.

That is what I want to guard against. We are very open on this subject now. There has been great publicity over it for months. I just want to make sure that after it's all over and we do our job in the next 60 days, that we do have a plan in place that solves the problem. And I am sure you do, too.

Thank you, Mr. Chairman.

The CHAIRMAN. Let me say, Senator Garn, that I do agree with you that part of the problem in the past is that we did not have enough regulatory cops on the beat. We were involved as you say, back in 1987, in trying to break out of the Gramm-Rudman-Hollings discipline so we could have enough people to do the supervisory job and to be able to pay them enough so that we had people of sufficient talent.

I went back the other day and read the record of the debate on the Senate floor. There was quite an interesting debate. Our colleague, Phil Gramm from Texas, who felt very strongly to the contrary, took the other side of that issue. We eventually won, but only after a fight.

I strongly agree with making sure that we are in a position where we've got enough people to supervise this system. If we don't have that, there is no way that we can be assured that this won't happen again.

I want to make one other correction for the record before yielding to Senator Heinz.

That is, we have in a sense done a recalculation of what we estimate to be the premium cost of using sort of the sidedoor financing mechanism—my phrase, not anyone else's here—and it looks now as if the total cost is a figure over a 30-year period would be a figure of $4.61 billion.

We will put our calculation in the record at this point as to how we reached that figure.

[The following was subsequently supplied for the record:]

One estimate of the additional cost of the proposed off-budget financing arrangements is $155 million a year or a total of $4.6 billion over 30 years.

Those figures assume that an additional 25 basis points will be paid each year on the $50 billion of REFCORP bonds and an extra 60 basis points on the almost $5 billion of FICO bonds that remain to be issued. The assumed spreads are estimates, possibly low estimates.

The CHAIRMAN. I had spoken earlier of a figure of about, I think, $3.75 billion. But the figure actually looks like it's about $4.13 billion.

Senator Heinz?

Senator HEINZ. Thank you, Mr. Chairman.

Mr. Secretary, I would first like to commend you on your iron pants. You have been seated there now for the better part of 2½ hours, and you haven't flinched under all this heavy questioning. I commend you.

I may be about to ask you a question about a sensitive subject.

The **Chairman**. Let's have order in the committee room, please. Excuse me, Senator.

Senator **Heinz**. I think we all understand that when the FDIC on February 7 moved into what was called a joint supervisory operation to take control of the 220 RAP insolvent thrifts, that one of the purposes of their doing so was to stop those thrifts from bidding up the price of deposits and to thereby lower the cost of funds in the industry.

That is not, of course, the only reason. But the idea was to keep these thrifts not only from losing more money but from making it tougher on other thrifts that were out there bidding for those deposits.

My first question is: Don't those insolvent thrifts depend on having continued access to those high-cost deposits just to keep their doors open?

Secretary **Brady**. I think you could make that case, yes.

Senator **Heinz**. I am not trying to make the case. I just want to know if that is the fact.

Secretary **Brady**. Without having interviewed them specifically, Senator, that would be my observation as well that that is what they are doing.

Senator **Heinz**. If that is so, then the next logical question is how does the FDIC lower the cost of deposits when they move in without providing a cheaper source of funds?

LOWERING THE COST OF DEPOSITS

Secretary **Brady**. You know, in the short term that is exactly the problem. In the longer term, as you resolve those—and I hope it's not the too much longer term and that legislation will be forthcoming—but in the longer term those thrifts would be resolved and they no longer would be out there bidding up the market in brokered deposits.

Senator **Heinz**. You are saying within the short run, having the FDIC in there, that there is nothing that they can do to lower the cost of deposit-taking?

Secretary **Brady**. It was pointed out to me that you could allow the deposits to run off. In other words, you would obviously have the problem of liquidating assets on the other side, which isn't necessarily a happy solution either.

We have also been trying to investigate the possibility of providing working capital for the FDIC as it does this during the next couple of months, and talked to the Fed about the possibility of doing that. We don't have a resolution yet of that problem, but it's directly aimed at the problem you are talking about.

Senator **Heinz**. What you are referring to is that there is the possibility of the Fed supplying funds to the FDIC at, shall we say, a much cheaper rate than the institutions can attract deposits to supply those deposits?

Secretary **Brady**. That is a possibility. However, it is theoretically only to be used as a last resort for liquidity. In the meantime, we would hope that you could let the deposits run off and sell some assets on the other side and keep that process meeting end to end.

Senator **Heinz**. Has what I will call for want of a better term a standby facility of the kind you have just described been established with the Fed?

Secretary **Brady**. Yes.

Senator **Heinz**. The vote on that was last week?

Secretary **Brady**. I am not sure when the vote was. But it's in place now.

I think the Home Loan Bank System and the Federal Reserve——

Senator **Heinz**. Let the record show that one of your able staff is nodding his head up and down yes.

Secretary **Brady**. You are exactly right.

Senator **Heinz**. But it is your hope that that standby or those standby funds will not be used?

Secretary **Brady**. I don't think so. I think the newspaper publicity about this problem is bound to make some people nervous. But the attraction of the Federal guarantee, the President's statement, the Federal Reserve Chairman's statement that the Government stands behind these deposits is sufficient.

Senator **Heinz**. I think that what you have said today indicates that the Government not only says that it is prepared directly, if necessary, to back up the deposits in the S&L's but that in fact the Government already has taken the most significant step it could take to back those deposits up so the depositors can have full faith. That step is that the Fed has gone on record as of last week in favor of supplying funds if those are needed.

Is that right?

Secretary **Brady**. That's correct.

Senator **Heinz**. Let me return to the cost of what is currently estimated as $126 billion over 11 years. That cost does not include interest payments after the year 1999. I may have my math wrong, but as I understand the interest payments on the bonds, they run at roughly $3.8 billion a year for the next 19 years, or mathematically about $72 billion more in costs.

FUNDING THE INTEREST PAYMENTS ON THE BONDS

How is that $72 billion, which is in addition to the $126 billion that we look at when we look at the 11-year plan, going to be funded? Is that mainly going to be out of Treasury general funds?

Secretary **Brady**. The largest amount will be out of Treasury general funds, but there will be funds coming from the industry as well.

I could get you that rate.

Senator **Heinz**. So, in addition to the $40 billion that the taxpayers will be putting out between now and 1999, the taxpayer stands to fund perhaps more than, but certainly as much as, $72 billion less some modest amount of $10 billion or $20 billion, not that $10 billion or $20 billion is modest, but it still means $50 billion more which the taxpayer will have to fund.

Are we talking about that ballpark?

Secretary BRADY. I can only give you precise figures—I only have OMB figures—out through the year 1999, which is the net budget outlays figure of $39.9 billion.

I think we can ask OMB for further figures, but I don't have them here.

Senator HEINZ. One last question, and my time is expired.

The CHAIRMAN. Senator Heinz, would you yield at that point? I don't want you to feel pressured by the clock because we want to finish today. We don't want to have the Secretary come back unless it is absolutely necessary, and I think we can finish today without having him testify a second time.

I think you have raised a very important issue here, and I think it is important to pause long enough to be certain that the Treasury, in fact, is acknowledging the numbers that you just used. I want to be sure that if the Treasury staff people, who are with the Secretary, feel differently or have another point of view, that we just don't go by this point in the record. I think you have raised a key issue, and I want to get the full light of day on it so we can understand where we are.

Secretary BRADY. Senator Riegle, what I would prefer to do is to get the exact figures from OMB, which shouldn't take too long, and get them up to you rather than agree or not agree with Senator Heinz.

Senator HEINZ. On the costs——

Secretary BRADY. The cost after 1999, the year 2000 forward.

Senator HEINZ. To what year?

Secretary BRADY. From the year 2000 forward.

Senator HEINZ. And we would like to know whatever offsets there might be to that.

Secretary BRADY. Absolutely. We will just continue this chart out that you already have in your possession.

The CHAIRMAN. If you will just yield further on that very point so we really nail it down because I have a similar interest to Senator Heinz.

Now, he has done a calculation that brings him to a total of $198 billion if I am adding your numbers that I heard you recite.

Senator HEINZ. What I did is add the $126 billion plus the $72 billion, yes, that would be your $198 billion. I was looking at the taxpayer portion of that, which would be $40 billion in the Secretary's plan, plus the $72 billion of interest payments which would not appear to be funded in any substantial way.

That means that of a total of $198 billion over the next 30 years, roughly $112 billion of that, or some 55 percent, would be taxpayer-supplied funds, if my calculations are substantially correct.

The CHAIRMAN. Do you generally follow the logic?

Secretary BRADY. I will get you the figures, but I want to be precise about them before we agree to them. So, I would prefer to get them to you, and we will get them to you very quickly.

The CHAIRMAN. I am happy to have that happen. Now that the numbers have been used, they will go out of this room correctly now.

I guess what I need to know is whether the Treasury—you or the Treasury staff—would be in fundamental disagreement on the general approach that he has used to make that calculation, even if the numbers vary some.

Do you substantially agree with what he is driving at in terms of the 30-year cost?

Secretary BRADY. Senator, I am neither one. I am going to get the exact figures and come back to you.

Senator HEINZ. One last question if I may.

On the zero-coupon bonds, $50 billion worth that will be purchased for $6 billion. What interest rate are you taking into account to reduce it to the present value 30 years from now? What do the discount tables show?

Secretary BRADY. I am informed it was a long-term Treasury rate of 7.8 percent.

Senator HEINZ. I am asking—maybe Professor Glauber would recognize this question from the Harvard Business School—what is the discount rate that will apply to $50 billion 30 years from now in order to have it worth $6 billion today?

Secretary BRADY. I think the figure is 7.8 percent.

Senator HEINZ. What is the interest rate on 30-year T-bills?

Secretary BRADY. You're talking about Treasury bonds, not T-bills?

Senator HEINZ. That is correct.

Secretary BRADY. I think it's about 9 percent.

Senator HEINZ. There is a substantial difference, Mr. Secretary, between 7.8 and 9 percent. I have to tell you, as somebody who respects you, that I can't understand how you can have the 7.8 percent as a cost of funds for the next 30 years when in fact the market is saying it's 9 percent.

Secretary BRADY. Senator, first of all, this argument is one that is raised in discussion about the budget. One side of the argument says how can you say 7.8 percent when it's 9 percent now. The other side of the argument says that interest rates don't stay static over time. If we do balance the budget, long-term interest rates will go down and, therefore, we could see interest rates of 7.8 percent or lower.

In my 35 years in Wall Street I have seen them all the way from 4 percent to 15 percent. So, I am not entirely persuaded that at any particular moment in time that any of us has the wisdom to be sure exactly what they are going to be, much less picking today's date as the shoving-off point.

Senator HEINZ. Mr. Secretary, my time has been expired. The chairman and Senator Bryan have been extremely generous to me with their time. You have been very helpful in your answers.

Thank you very much.

The CHAIRMAN. Thank you very much.

Senator BRYAN. Thank you very much, Mr. Chairman.

Senator Heinz, I enjoyed the colloquy and found it very informative.

FEDERAL REGULATORY POWERS ARE LIMITED

Mr. Secretary, let me return to this regulatory concept. If I understand the present state of the law, there is no general inherent power that resides within any of the Federal regulatory agencies to impose a limitation on the powers that State-chartered savings and loans exercise. Am I correct?

Secretary BRADY. That is correct.

Senator BRYAN. And the way that we try to get a handle on that and we acknowledge in this room has been an abysmal failure has been that we withhold the Good Housekeeping seal of approval, the FSLIC insurance stamp. But in the past, have you not had the authority to say to an institution, look, you've run so far amok that we come back with all the FSLIC?

Secretary BRADY. I would have to look that up, Senator Bryan. My understanding is that once you get a charter, you're off and running and the amount of control that FSLIC has over you at that particular point in time is very limited.

Senator BRYAN. It is my understanding that the FSLIC could withdraw that or refuse to give it the imprimatur. But assuming for the sake of argument that you are correct, your testimony is clear that you would give that power prospectively under the law that you are asking the Congress to adopt.

My question is: Shouldn't we approach this more directly rather than indirectly and say to a State-chartered institution, you must comply in fact with the regulatory scope of whatever we authorize in terms of the range of investment options that you are allowed to participate in, rather than play the game where we're not going to give you the FSLIC stamp, we are going to give you the FSLIC stamp?

Secretary BRADY. I think it would be hard to say to State organizations that they have to do it to the letter of the Federal law. I think it's a better system, although it might be slightly captious to say, you do what you want but if you want the Federal insurance, here's what you have to do.

So, if they want to create a savings and loan institution in Nevada or New Jersey that has broader powers, they can do so, but it only qualifies for Federal insurance if it meets certain guidelines. You could actually have, some have suggested, institutions that could do both: some part of the deposits are guaranteed and some aren't, depending on what the investment policy decreed.

Senator BRYAN. I guess my concern is that in light of the track record in which the industry, with tacit if not outright approval, developed this byzantine accounting system, is going to be very reluctant, once the savings and loan is chartered, once FSLIC is given the stamp of approval, to withdraw that.

There are internal pressures that build: We can't do it now; it will send shock waves through the industry. All sorts of things that my reading of the history of this suggest occur.

Secretary BRADY. I would hope not. It hasn't turned out quite that way in the operation of the FDIC, and I hope that method of operation would come forward into the new organization.

Senator BRYAN. Let me shift focus if I may with the moment or two I have left.

My understanding is that one of the reasons that we have engaged in December of last year in rather extraordinary methodology in terms of the resolution of these insolvent institutions was because the fund itself was bankrupt.

You all simply had no money to liquidate the savings-and-loans that were insolvent and pay off the depositors. Am I correct in that?

Secretary BRADY. The FSLIC had no cash.

Senator BRYAN. It had no cash. So, we couldn't get the depositor at this particular savings and loan the $15,000 or $20,000 or $25,000 that he or she had in the account.

Part of the plan, as I understand, is to recapitalize FSLIC. And to do so you are asking the industry to come up with an added premium. Am I correct in that, sir?

Secretary BRADY. That is correct.

Senator BRYAN. My question then is this:

If one looks to page 14 in your prepared testimony, in terms of financing prospectively the resolution trust corporation, as well as, looking at the bottom of the page—that is, providing funding, in part, for the $40 billion of the resolutions already effective—you are calling upon the industry to contribute a portion of their insurance premiums.

My question is: If this fund has virtually no capitalization at all, if, as I believe the plan contemplates, we want to fully recapitalize that fund—and I think most of us here would agree that has to be done—my question is how can we recapitalize the fund and at the same time we are asking the industry to pay higher insurance premiums and say, look, a portion of those premiums have got to pay off the resolutions that we contemplate that will occur prospectively from the resolution trust corporation, and those resolutions that are already effective in December of last year, which account for some $40 billion?

Secretary BRADY. Well, Senator, let me see if I understand your question. You are saying how can we ask them to do both of those things?

Senator BRYAN. In other words, there seem to be, Mr. Secretary, an acknowledgement at least by a number of members of the committee if not all that there is a limit which you cannot impose an additional burden upon the industry, or that healthy portion of the industry would itself find itself in financial difficulties. And presumably, in crafting this plan, you have made, as you told us, a very delicate balance. You have asked the industry to come up with so many dollars. Ultimately the taxpayer is going to have to come up with so many dollars.

In crafting the balance, my question is: How can you say on the one hand that you have asked them to come up with additional money for insurance premiums and then in effect divert that insurance premium from FSLIC to in effect capitalizing the resolutions prospectively and those that occurred prior to the end of the year? It seems to me that we are acting at cross purposes.

Secretary BRADY. I think what you have to do is view the problem in total. We have the job of paying off the obligations which were incurred before 1989, and we have the job of funding and paying off the obligations which are going to be resolved for some $50 billion.

The question is in total how much can you charge the industry to do that? Then after that, when you're through with that, how much goes to the account of the taxpayers?

In trying to come up with the quiltwork that goes into this kind of a plan, you simply have to mix and match and see how much you think the industry can stand, whether you put additional premiums on them, whether that places the savings and loan industry in an impossible position with respect to competing with banks. If you put too much of a burden on the industry, are you making sure that it is getting passed on to depositors and isn't absorbed into the profit margin?

The only thing I can tell you, Senator, is by staring at the problem for 3 months, you finally get some feeling from the people that have worked on this as to how it is all going to go together. And I can't answer your question much more precisely than that except to say that the problem is not only retrospective with regard to the $40 billion that went before but it also looks into the future to see how we're going to fund the $50 billion that we now need, we hope, to complete the resolution.

Senator BRYAN. If the chairman would indulge me one more question. I know my time is up.

Would you concede, Mr. Secretary, that if we did not force, as your plan would do, a diversion of those increased premiums to finance both that which was done prior to the end of the year and that which is going to be done prospectively under the resolution trust corporation, that we'd build up that FSLIC fund sooner?

Secretary BRADY. It would, but then we would have to get somebody else to pay for some of the other costs, some of the other moneys that are needed to take care of the past. So, it's as long as it is wide, I am afraid.

The CHAIRMAN. I have two or three important final items to raise with you here.

One, I want to go back to something that you had indicated earlier. You made a reference to a conversation you and I had by telephone before the end of last year to sort of talk about the issue of——

Secretary BRADY. It was very near the end of last year.

The CHAIRMAN. It was very near the end of last year, when a lot of the deals that were in the works were being consummated at the Federal Home Loan Bank Board. And I think the way you described it pretty accurately covers it, although I want to add a point or two because it's important that people understand what happened.

And that is, in calling you as I did, I was concerned about the fact that we were, through the use of tax credits particularly, obligating a drain on the cash drawer of the Federal Government in the future of some unknown amount.

I think it's fair to say you had a concern along those lines also.

Secretary BRADY. Absolutely. Your question was very well founded. I just couldn't give you the answer then, and that was my point.

The CHAIRMAN. As we talked about it—because as the Treasury Secretary you are the fellow who probably more than anybody else has to try to guard the cash drawer of the Federal Government to the extent anybody can, you are the person to logically address that question to—you felt that you were limited because it was an independent agency and as you examined the question overnight, it was not really clear that you had a kind of an operating authority where you could reach in and try to have an impact directly on the decisionmaking.

Is that really a fair way to describe it?

Secretary BRADY. Exactly.

YEAREND DEALS

The CHAIRMAN. I think it's important to note that there were a lot of us who had a concern about some of those deals that were being done up against yearend where there were very large tax expenditures in the future as part of those deals.

Secretary BRADY. Senator, yours wasn't the only call. I had calls from a number of Senators on the same subject.

The CHAIRMAN. After we spoke, it became clear that there really didn't seem to be any way to interdict that process of spending tax money in the future, several billions of dollars.

And the part that is on the record is that I then asked the GAO, and informed the Federal Home Loan Bank Board that I was doing so, that we were going to examine every single one of the deals done in December. We would look at the financial impact, were they fair, was the competition as it should be, et cetera.

The GAO is going through that. Each one of those deals, by the way, has paperwork associated with it that is about 18 inches high on the average. Each one is different. So, they are very complicated. No two are alike. So, it will take a while to reconstruct what happened.

But that reconstruction is taking place, and the time at which it's done so we can understand these deals one by one and deals in the aggregate. We will have that information presented to them before this committee, and we will have a better sense as to precisely what the obligations in the future are.

I don't know if you want to add anything to that. If you do, feel free to. Then I want to go on to something else.

Secretary BRADY. No, Senator.

The CHAIRMAN. President Bush said in the meeting we all attended together that it was the intention of the administration to be flexible on these packages. It wasn't set in concrete. This is the general approach you wanted to take and thought it through; this was the structure that you wanted to put in place, but that the administration was open to some give-and-take as we refined it and send a finished legislative project down to the White House for his signature.

Is that a fair summary of his view?

Secretary BRADY. Very fair.

The CHAIRMAN. We are going to work along on that basis. I think there are some adjustments that we will need to make. Some of it relates to questions that even now aren't fully resolved. Some of you touched on the logo on the door of institutions, precisely how it is to be financed, et cetera.

Let me give you a couple of suggestions to think about today because we have done a lot of work on this with you in the time since we have started. If we were to take your idea of considering the savings and loan industry of the future to be centered around housing, and let's say we raised the percentage of activity that a savings and loan dealt with that related directly to housing up from 60 percent, say, to 70 percent, then you have in addition, you have whatever the kind of related activities are that you would wrap around that central focus. Then we could take a look at what might constitute an appropriate profile of activities that go around that to give you a balance and let you be profitable and let you attract capital so we can get up to a nice high, sufficient capital standard.

I asked that question earlier as to what these wraparound activities might be, but that then, in turn, relates to another point we were discussing earlier; that is, the degree to which States one by one can go out and add on additional operating authorities and play it all back in on the Federal deposit insurance system, which is exactly what has happened in the past.

To me that is probably the single largest part of the problem. When you take a look at where the S&L's have gone down, the greatest numbers with the greatest numbers of assets, they have been in the States that have gone furthest in terms of these wide-open charters of activity.

I have to tell you, frankly, I think it's irresponsible for this Government to insure one dime of activity that the States may dream up that we haven't authorized and clearly thought through at the Federal level.

I think if we are going to have a Federal deposit insurance system, then we ought to have a Federal charter of activity to these institutions and those are the outer bounds. If people want that charter and they want that deposit insurance, then they play within that playing field.

Now, what we include in that we can discuss. Whether the housing is 60 percent or 70 percent or some figure and then the other related activities that make a coherent operating charter is called when we add that up, that's what it means if you're in this business. If you want to get in it, that's what you do. If you don't want to get into it, you stay out of it and do something else and put the Federal deposit insurance underneath it.

I have to tell you that I don't have much appetite for saying to the American people, my constituents or the rest of the other 49 States, look, we want you to sign up again with the Federal deposit insurance system and be on the hook to have to make up any insolvencies or insufficiencies in the future, but we can't tell you today exactly what it is these S&L's are going to do in the future—or whatever we have to call them.

I don't think that is responsible. I don't think people are going to buy that, and I don't think they should be asked to buy it.

And I think if you are going to have a Federal deposit insurance system we ought to decide right here—the President, the administration, the Congress together—what this business is and have a little bit of latitude in it. We ought to decide what it is, and that's what is then positioned on top of this Federal deposit insurance system.

I feel very strongly about shearing off this exercise in Federal authority. If the States want to create their own kind of institution, if they want to go into the insurance business, et cetera, to fund their own kind of business, then let them try to do it.

We have seen some failures in State insurance systems. We have seen it in Ohio. We have seen it in Maryland. But I don't want to see the Federal Government on the hook for that kind of activity.

I have to tell you very frankly, regulators come and go. Sometimes you get a good one, sometimes you get a lousy one, there is no guarantee as to what you are going to get. It has nothing to do with party, it's just sort of the way the thing works.

I don't want to leave a question this big to regulatory discretion, because regulatory discretion by itself isn't a sufficient safeguard, in my view. And when you sort of wake up one day and find that $100 million has disappeared and the Federal taxpayer is going to have to pay most of it, I think we have an obligation to put in place a system with safeguards that are very much stronger than what we have seen in the past and go directly in dealing with the problems that seem to be at the heart of why we are in this disaster.

So, I want to urge that on you, and I think that is a view that is shared by a number of my colleagues. We don't know quite yet how many because we are still in the discussion stages on this.

But I think you have a reputation—I mean a guy with your past history and up to the present day who has been very careful as to how money is managed—to make sure things are prudent, to make sure they're sound, to make sure that if we're going to obligate ourselves to something that we really have a sense that we have got a discipline in place that is going to hold up.

I feel exactly the same way. We can't afford to miss with the solution. I think when we put this reform package in place, it's got to be solid and it's got to work; and it's got to hold up after 2 or 3 years and all the way into the future.

I don't want to find us in a situation where it's $100 billion now and 3 or 4 or 5 years from now it's another $100 billion, another $200 billion. I think there is a risk that could happen.

Let me give you another suggestion to think about. If we are going to center this industry more directly around home mortgage lending—which is what your paper suggests and which I agree with—and if we up the percentage, which I would hope we would consider doing, maybe what we ought to do is actually call these institutions something different than what we now call them.

There is really no particular magic in calling them a savings and loan institution. Maybe we ought to call it a national housing bank where people understand the purpose of that institution. They go and save there, they have some sense as to how their money is basically going to be used. In many cases it's going to be used for their own benefit because it is cycled back out principally in home lending. It's mortgages for themselves, their neighbors, their kids, and so forth. We think there is a certain value in that.

But I think we are going to have to do a better job of defining exactly what this business is going to be in the future. And we talked about that earlier.

I want just to raise one other issue with you, and it is the specific issue that you have raised before and we were not able to complete it.

That is, if we stick with the timetable which you are talking about now, within 2 years, institutions out there may have a network but it isn't up to as high as 6 percent of the capital or 6 percent capital standard, that they've got that time period to get up to that point, and if they don't, then presumably they are out of the game.

I would like you to illuminate that. What happens at the end of the 2-year period if they haven't made it to the 6 percent?

OPTIONS IF AN INSTITUTION CANNOT MEET THE DEADLINE

Secretary BRADY. Well, Senator, they have some options. Obviously, if they haven't made it, they have exhausted any availability of capital from their own shareholders. They have tried that and they couldn't do it or they didn't want to do it. They have talked to other buyers, corporate buyers of one kind or another, and they couldn't interest them in buying into a particular savings and loan. But they have the opportunity to merge with another S&L. It isn't necessarily disaster from their point of view.

What it may very well mean is a bringing together of institutions. One had 8 percent capital and another 4 percent. The two of them would merge together, and you would have 12 percent between the two of them, divided by 2 and you've got 6 percent.

So, I don't think it means they're going out of business. I just think it means that when we get through here, we are going to have a series of strong units which will be able to do the kind of things that you have just illuminated in your ideas to think about in the last few minutes.

So, I don't think they're going over the wall. It's just a question of doing something else slightly differently.

The CHAIRMAN. I think you take the best case. If you can find one that has got extra capital and one that is deficient on capital. And the numbers merge and work out to 6 percent. What about the ones that can't get up there? I am asking what happens to those which don't find merger partners, can't raise the capital, fall short of the time deadline. What happens to them?

Secretary BRADY. Let me say first of all—I will get to that in 1 second—we have had a history of this kind of consolidation in industries over the years. We had mom-and-pop grocery stores, then we had supermarkets. Now we are going back to mom-and-pop grocery stores again. I am not sure that there is any pattern there.

But let's take the worst case we can think of, a guy that's got 1 percent capital. If he can't find a suitable merger candidate, if he can't raise the capital himself, then I think he's got to liquidate.

But the offset to that is we've got a sound industry when we are through. You pointed it out earlier. There is some pain here, and what we have to do is make sure that the taxpayers in the future faced with what they are facing aren't today—a $90 billion bailout.

There is going to be an awful lot of egg to go around for everybody here if we do this again. Maybe we ought to be shot.

The CHAIRMAN. I agree with you. But let's just take your example. If you've got an outfit that has got a 1 percent capital situation and they have to liquidate—if that's the worst case—let's take one that is maybe 4 percent, they couldn't quite make it to the 6 percent, they couldn't find a merger partner and so forth.

So, you've got somebody at 4 percent and they've got to liquidate, but in the course of liquidation, you just have got to basically unload what you have, you may or may not receive full value of what shows up on the balance sheet.

Isn't there a risk in that case—and maybe it's one we have to face; I don't make a judgment on that right now— but isn't there a risk in that situation if you have any large number that hit the deadline and have to then shut down and go out of business and liquidate, that we may in fact have another shortfall there that somebody is going to have to pick up.

Secretary BRADY. Senator, I don't see it that way because in other industries, when they are faced with changing economic circumstances, they do something about it. The guy that is chairman of the board and president is responsible to the shareholders who own that 4 percent S&L. He probably owns some shares in it himself. He is going to try to do the very best thing for his own shareholders and depositors. I think he will go out, if he can't make it up to 6 percent, and merge with somebody in the neighborhood that is in a position to do that.

So, I don't see it as a black-and-white situation. I really don't. This kind of thing, you don't see businesses in other industries just going out of business faced with this kind of economic circumstance. They do something about it. They go raise capital. If they have to raise capital, it may mean that their return to their own shareholders is a little less, but that is the price of being a participant in the S&L industry in the future.

The CHAIRMAN. The problem is you've got an awful lot of people in that category, and if they don't make it up and they have to liquidate and they're short in terms of how much liquidation value they get in terms of paying off their depositors, you've got a claim against the insurance fund, and the insurance fund is you and me.

What I am saying is if you're going to march a whole lot of people through that exercise—and we're talking about several hundred institutions that are in that in-between category; they may be able to climb out and fall back in a situation where they can climb out.

I think we've got to do a better job of putting a dollar estimate on what the fallout might mean. If you get any substantial number of the middle group that doesn't make it, we're likely to get sort of a second wave of claims coming in against the insurance fund.

Secretary BRADY. Senator, if I could just reply to that. In the Resolution Trust Corporation for which we suggest $50 billion be raised, there is a very substantial cushion inside that organization of some $10 billion. In all of our estimates leading to the figures which were gone through by OMB, there also are estimates included for the effects of asking the S&L industry to get to 6 percent.

So, we have put those into our calculations. We would be glad to share them with you.

The CHAIRMAN. I will just say for the record that the number of people that are at 6 percent or higher now represent 24 percent of the industry's assets. So, you've got 76 percent of the industry's assets on a sliding scale coming down below 6 percent. I can give you the breakout below that.

But I only say that to indicate that the size of the group that is not insolvent but short of the 6 percent is really the largest part of the industry, both by numbers of institutions as well as percentage of assets. So, the question of the dynamics we set up as to whether or not they can lever their way up, climb up, build their way up to the capital standard within the time period that we have talked about is a very important question. If they don't make it, then they have to be unwound. I think we have to track through what any sort of large-scale unwinding of that group would mean, what are the financial consequences and how much of that falls back on the system.

I don't think I have a clear view on that yet. If I may say just one more thing—and I appreciate your patience here—I will finish up as quickly as I can.

This morning in three major newspapers, the Wall Street Journal has a story saying "Bush, S&L bailout creates illusion of deficit cut."

The New York Times, "Bush S&L critics see a lot of holes in plan."

The Wall Street Journal says, "Analysts call Bush's plan for S&L's overly optimistic."

I only cite those because that's today's news and you've got three major national papers taking their own look at this thing and expressing in major stories a lot of skepticism about whether the financing side of the plan really holds together, whether the assumptions are sound, whether they can work out, and whether we have really estimated the size of the problem correctly.

We have just received the financial statement very recently. The source and application funds that we have asked for, and all of the underlying assumptions from which that is built. We are going through that. There are still some questions in our mind that are very incomplete. In other words; there are some gaps in our ability to really sort of understand all the pieces and how they connect. We need to have that.

So, I just tell you that because it's very important that we continue the discussions that we have had so that we can really close the loop in understanding precisely all of the financial mechanics.

I assume that you will have no problem in that area?

Secretary BRADY. None.

The CHAIRMAN. I appreciate that, because that is one area where we still have some work that needs to be done.

With that, I want to say to you I appreciate the job you're doing. It's a tough job, and this is a tough business, and sometimes you get an elbow in the eye when you don't deserve it. We have all had that happen.

I appreciate the work you're doing, and I appreciate the work your staff is doing. I appreciate your patience today.

We are going to solve this problem. We are going to have to make some adjustments, and maybe meet in the middle here and there. That is certainly the intention on this side. You have so as well from your side of the table. In that spirit, we will answer this problem in ways which will give us some solutions which will withstand the test of time.

Secretary BRADY. Thanks for your help.

The CHAIRMAN. The committee stands in recess.

[Whereupon, at 1:25 p.m., the committee was adjourned, to reconvene at 10 a.m., on Thursday, February 23, 1989.]

PROBLEMS OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC]

PART II OF IV

THURSDAY, FEBRUARY 23, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, at 10:05 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Dodd, Dixon, Shelby, Graham, Wirth, Kerry, Bryan, Garn, Heinz, D'Amato, Gramm, Bond, Mack, Roth, Kassebaum, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me invite those in the room to find chairs if they can so we can get started this morning.

I want to welcome back to the committee for a second stop this week the Chairman of the Federal Reserve, Alan Greenspan. We are delighted to have you with us.

Your earlier discussion, of course, dealt with monetary policy and today you are here to deal with the FSLIC savings and loan issue and to discuss with us your thoughts on the administration's plan.

Certainly, you are one of the people, I think, who are most important for us to hear from on this issue. You were among those invited by the President to Camp David, as I understand it, to discuss the proposal prior to its finalization, and therefore I assume you had your chance for input along the way.

It seems to me that the Federal Reserve is involved directly or indirectly in this matter in a number of ways. Certainly, huge sums of money are involved.

In our hearing yesterday, Senator Heinz, who is here today, and others were raising the question as to what the real cost is likely to be and the estimates, even since the plan has been announced, have been moved around. We are interested on not only the total amount of money, but also how it is to be financed and what kind of impact it might have, for example, on financial markets and to the economy more generally.

A critical factor in estimating the cost of the overall plan is the set of economic assumptions that are made.

The administration is projecting yields on long term Treasury bonds to fall in the next 2 years to 6.2 percent, which would be the lowest rates since 1973. The rate on floating rate FSLIC notes is projected to fall to 4 percent in 1994, which appears to imply the lowest short term interest rates we have seen in a quarter century.

There is naturally skepticism about the realism of those kinds of economic assumptions, and there have been a number of articles that have appeared now that cite the view of a number of outside observers expressing skepticism about both economic assumptions and also the total estimated cost.

Earlier this week when you were here, you testified that you thought that the financial markets had already discounted this problem because it has been so much in the news, and your precise quote was to the effect of "The market understands the size of the hole that exists in the savings and loan industry and the borrowing requirements to fill it."

If that is so, that of course raises the question of on budget versus off budget borrowing and the cheapest way to finance the proposal.

I think it is the view of most of the members of this committee, and certainly my view, that we ought to try to finance this at the lowest possible cost, particularly because the taxpayer in the end is going to have to shoulder a large part of the responsibility of paying for this problem.

We certainly don't want to pay any additional cost because of an elaborate financing mechanism, without some very good reasons.

Also, of course, the Federal Reserve Board is the lender of last resort, and the committee is of course interested in any policy or contingency planning that the Fed, together with the Federal Home Loan Bank Board, may have developed and put in place that would ensure that absolutely not one penny deposited in a federally insured account is lost by a depositor within the insurance limits.

Certainly, we in the Congress and the President have made that guarantee very explicit time and again, but it is important that we understand what kinds of backup arrangements may be in place.

There are other areas in which the Federal Reserve Board has particular expertise, on which you can well advise the committee. They include among those the following:

Any steps that regulators might take to stop the discount rate war that has broken out in Texas and in other areas of the country.

The ease or difficulty with which the financial markets can absorb an extra $50 billion of 30-year bonds, and whether a different mix of maturities might be easier for us to finance.

I very much want to hear your thoughts on the overall soundness and wisdom of the administration's regulatory and structural reforms, and I would like to hear any suggestions you may have for areas of that plan that may need adjustment.

You have had additional time to think about it. It may not be exactly what you might have recommended. So we would be very interested in hearing any suggestions you have for adjustments or modifications to that plan.

We have invited you to follow Secretary of the Treasury Brady because we hold you in very high regard and consider your thoughts very important on this issue.

With that, let me yield to Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

Mr. Chairman, we are happy to have you before us today. I am well aware of your ordeal this week. This is the third day in a row, twice before us and once before the House Banking Committee. So I am looking forward to your testimony.

I will take none of your time and try and ease your burden by shortening the length of this session.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman Greenspan, I would like for you to focus some of your attention on the accuracy of the proposed plan from interest rates on and the total cost. A lot of us would. I know a lot of us are very interested in this. We are looking at it. We are looking for a plan that is going to work, but we are also looking at the true—as far as we can calculate it—the true cost to the taxpayers, to the thrifts, and everybody else.

Thank you, Mr. Chairman.

[The complete prepared statement of Senator Shelby follows:]

STATEMENT OF SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, I want to join my colleagues in welcoming Chairman Greenspan back before the committee for his second visit this week. I would like to say that we appreciate your availability as well as your candor on this important topic.

We now have the bill in our hands. As it is more than 330 pages long, I cannot profess to have read it yet, but I trust that its content merely amplifies that which we have been discussing. Secretary Brady testified before this committee yesterday and while I was unable to attend yesterday's hearing, I am very interested in that which was disclosed.

It seems that the Treasury figure for handling the resolution has climbed yet again, as Secretary Brady admitted that the interest payments for the years after 1999 has not been included in the earlier totals. This fact, coupled with the fact that Treasury's interest rate assumptions are quite optimistic, makes me skeptical that this proposal is all that well conceived. While I recognize the difficulty in calculating future revenue streams from the sale of assets, these omissions or errors are of a very different sort. Not calculating 20 years of interest, the cost of which will be borne by the taxpayer, is either stupid or deceptive. And I must say, that thus far, I've found representatives of the Treasury to be quite intelligent.

Chairman Greenspan, the Federal Reserve has signed off on this plan. I am sure that you realize that we cannot adopt a resolution to this crisis without calculating, as accurately as possible, its ultimate cost. I believe that it is incumbent upon you, as a sponsor of the administration's proposal, to assist us in factoring out Treasury's errors or omissions, to get a final total.

I am also concerned about the Treasury's calculations on what the thrift industry can pay toward this resolution. I am in agreement with the administration that the industry should pay all that is possible. While I am cognizant of and sympathetic to the complaints from the healthy part of the industry that they are not responsible and thus should not be liable for the faults of their colleagues, I still believe that assessing the industry itself is far more equitable than assessing the taxpayer. However, if we are going to maintain a separately chartered, separately regulated thrift industry, we should provide for its strength and viability. I am concerned that the present proposal may make unrealistic assumptions about what the industry is capable of contributing. I would appreciate your assistance in determining whether or not the assumptions in this proposal are valid.

I believe that the spirit of cooperation, between parties and among the branches of government, is essential if we are to expeditiously agree upon a resolution. However, while we are in this discussion phase, it is equally important that we maintain a healthy skepticism of each other's ideas and conclusions. There is an adage that says that if two parties agree on everything, only one is doing the thinking. I commend the Department of the Treasury and the White House for submitting quickly a comprehensive proposal. However, it is now our responsibility to check and doublecheck it for accuracy and viability. We need the assistance of the Federal Reserve, the regulators, the industry, and outside analysts to accomplish this task.

Chairman Greenspan, once again we appreciate your being here and your willingness to work with this committee and others to resolve this financial crisis. I look forward to your testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Shelby.

Does anyone have a time requirement that we ought to be sensitive to here in terms of another committee they need to go to?

Senator PRESSLER. I am just going to put a statement in the record. I do have a brief statement.

The CHAIRMAN. Let us call on you now, and I think Senator Heinz also has time pressure.

Senator PRESSLER. I shall place my statement in the record.

I think we should proceed on the basis that everybody is telling Congress we should cut the budget, balance the budget, and that is extremely important and I agree with it, but as these hearings progress I wonder if we are really participating in truth in legislating in terms of telling the American people what this really costs and whether or not it should be on budget.

I think the Wall Street Journal had an article the day before yesterday, and I ask unanimous consent to place in the article——

The CHAIRMAN. Without objection.

Wall Street Journal
FEb. 21, 1989
Page A-18

Bush S&L Bailout Creates Illusion of Deficit Cut That Congress Questions but Wants to Believe

By Alan Murray
Staff Reporter of The Wall Street Journal

WASHINGTON – The savings-and-loan crisis looks like a bonanza when viewed through the strange prism of President Bush's fiscal 1990 budget.

It shows government spending on deposit insurance *declining* by $14 billion from the current year. That's enough to pay for the president's new spending initiatives three times over.

The $14 billion windfall, of course, is a mirage. Government spending on insolvent savings and loans will actually increase substantially in the year beginning Oct. 1. But, with some accounting sleight of hand, that huge liability has been turned into a sizable asset, easing the administration's budgetary squeeze.

"I'm amazed, amused and bemused," says Carol Cox, director of the bipartisan Citizens for a Responsible Federal Budget. "Would you believe the thrift crisis is going to save us money and reduce the deficit? Well that's just what the budget says!"

The deposit-insurance artifice, involving off-budget financing, is the biggest in a bag full of tricks that Budget Director Richard Darman used this year to pull off a remarkable budgetary coup. His proposal included a far sparser rise in overall government spending than any Reagan budget. But it is skillfully packaged to emphasize spending increases and obscure painful spending cuts.

As a result, it's the first budget in eight years to escape the fate of being declared "dead on arrival" by Congress. Concludes Ms. Cox: "Dick Darman is the smartest person I've ever observed."

Fiscal 1990 Federal Outlays Projected for S&L Bail-Outs

Total S&L spending	**$31.2 billion**
Off-budget borrowings	-25.0 billion
Other offsets	- 4.3 billion
On-budget spending	**$1.9 billion**

Source: Office of Management and Budget

The reduction in budget outlays for the savings-and-loan rescue stems from the administration's plan to create a new company, called the Resolution Financing Corp., which will borrow $50 billion over the next three years by selling long-term bonds. The company will be modeled after other government-sponsored but privately owned enterprises, such as the Federal National Mortgage Association (Fannie Mae). And like Fannie Mae, the new corporation won't be part of the federal budget.

The money borrowed by the new corporation, however, will simply be handed over to the government, and will appear on the federal books as a "receipt." Thus, rather than increasing the budget deficit, the scheme actually *reduces* it.

Defenders of this artifice argue that the bond sale should be off-budget because it doesn't have the same economic effects as most types of deficit spending. While borrowing to finance government spending drains the nation's pool of available capital, borrowing to rescue thrifts doesn't. Instead, it merely transfers capital from bond buyers to thrift depositors.

Budget experts say the new borrowing ought to be counted in the budget. "It gets to be a murky legal issue," says Rudolph Penner, former director of the Congressional Budget Office. "But conceptually, forgetting the intricacies of accounting, I really do think it should be counted as federal borrowing."

Moreover, by creating a new borrowing agency, the government will be forced to pay a higher interest rate than it would on straight government debt, increasing the taxpayers' cost by anywhere from $2 billion to $8 billion over the life of the bonds.

"This is not just an arcane, inside-the-beltway bookkeeping dispute," says GOP Rep. Willis Gradison of Ohio. "The Treasury plan is a highly creative accounting shell game which gives a windfall to the purchasers of $50 billion of new debt in order to be able to argue that the FSLIC rescue should be off-budget. That's a mighty high price to pay for appearances."

Budget accounting rules, established by a federal commission in 1967, allow an organization to be taken off the budget if it is privately owned. Administration officials argue that the Resolution Financing Corp. passes that test. They say it isn't any different than the Financing Corp. set up two years ago to raise money for recapitalizing the Federal Savings and Loan Insurance Corp. Both the Office of Management and Budget and the Congressional Budget Office agreed that that corporation could be treated as an off-budget entity.

But Financing Corp., or FICO, bonds were financed totally by money from the S&L industry. In the case of the new corporation, two-thirds or more of the interest payments on the bonds would be paid by Treasury, making it difficult to argue that the corporation isn't part of the government.

Thomas Stanton, a Washington lawyer who specializes in government-sponsored enterprises, says the new corporation "clearly and unambiguously fails the private-ownership test." And the Congressional Budget Office sent a memo to the House Ways and Means Committee last week that said putting the new corporation off-budget may damage "the integrity of the unified budget, the meaning of the budget deficit, and deficit-reduction efforts."

Mr. Darman, however, doesn't share that view. "Some people will make the argument, including perhaps some in the Congressional Budget Office, that the payment of interest by Treasury changes the budgetary treatment," says a spokesman for the White House budget office, "We do not accept that argument."

And despite the Congressional Budget Office's complaint, Congress is likely to accept the administration's legerdemain. That's because, like the White House, members are anxious to meet the Gramm-Rudman law's deficit-reduction targets this year, without facing the political pain of excessive spending cuts or tax increases.

Rep. Gradison has proposed, as an alternative, putting the borrowing for the S&L bailout on budget, but exempting it from the Gramm-Rudman targets. Other members of Congress, however, don't want to vote for an exemption to the budget law. Administration officials fear an explicit exemption from the deficit-reduction targets would open the door for Congress to exclude other spending programs.

As a result, the unusual financing scheme seems likely to become law. "In the end," says Mr. Gradison, "it's easier to go along."

Senator **Pressler** [continuing]. Stating that this was actually a very misleading budgetary accounting procedure that we are going through here, that we are dealing with a fraud here. The savings and loan part of it is a fraud. It would be a bigger fraud on our part to the American people if we don't tell the truth about what it costs and put it on budget or put it where it is supposed to be so we know what we are doing.

The whole town is sort of—well, everybody is saying cut the budget, but the President's speech had no specifics as to where; that is, his speech to the nation.

We are maneuvering this particular issue in a way that is off budget, and so forth, and not really saying how much it costs.

I heard Senator Heinz on the radio last night being quoted that $110 billion in taxpayers' money, $90 billion in individuals. This is much higher than I had previously heard, and I think one thing that we have to perceive in this committee is the truth in legislating for the American public about what this is really going to cost and put it on budget if necessary.

The **Chairman**. Thank you very much, Senator Pressler.

[The complete prepared statement of Senator Pressler follows:]

STATEMENT OF SENATOR LARRY PRESSLER

Senator **Pressler**. Mr. Chairman, it is a pleasure to welcome Chairman Greenspan back to this committee. His appearance here today is most timely, following the introduction yesterday of S. 413, the Financial Institutions Reform, Recovery and Enforcement Act of 1989. I surmise the acronym of FIRREA already is being bandied about in the Halls of Congress and in some of our financial districts.

In any event, S. 413 is a comprehensive and complex piece of legislation on which we shall need sound expert advice such as that we will hear today from the distinguished Chairman of the Federal Reserve Board. I look forward to his testimony.

Thank you, Mr. Chairman.

Senator Heinz.

Senator **Heinz**. Mr. Chairman, I have a prepared statement I would like to put in the record.

I have a couple of observations I would like to make. I also have to depart briefly for a couple of other committees, but I would like to return to see Chairman Greenspan.

Alan, we welcome you. The first observation is, after what happened to the stock market and the dollar yesterday, I fear that your tough talk about how the Fed intends to fight inflation may make you the moral equivalent to the markets of what Salman Rushdie is to Islam. [Laughter.]

Second, I have noted a number of statements in your prepared testimony, four of them. One, the cost and competitive distortions involved in subsidized borrowings from the Federal Home Loan Bank Board militate against a separate thrift industry.

Second, the dangers inherent in special regulatory and supervisory regimes for subsidized depository institutions would render a separate thrift industry unwise.

Third, the continued vulnerability of a large part of the thrift industry to continued interest rate swings would, in effect, render a separate thrift industry subject to considerable risks.

And in the same vein, the secondary mortgage market may make it unnecessary to provide special government subsidized facilities for mortgage lending.

I fear that where prospective home buyers, home builders, and the thrift industry are concerned those may seem like Satanic Verses.

I would be back, I hope, to ask you some questions about how you really feel about having a dedicated home mortgage industry.

Thank you.

[The complete prepared statement of Senator Heinz follows:]

STATEMENT OF SENATOR JOHN HEINZ

Senator HEINZ. Mr. Chairman, I join you in welcoming back Chairman Greenspan to our committee for the second time this week. Today, however, Chairman Greenspan is here to discuss a different kind of monetary policy and a much different kind of deficit. More precisely, we are here to examine the best policy for providing monetary aid to the thrift industry to fill a multibillion deficit in the thrift industry.

In economic terms, it seems as though the demands of depositors far exceed the supply of assets in our Nation's savings and loans. The problem started with a rapid acceleration of the interest rate followed by a sharp contraction of the thrift industry's net worth. Due to an expansion of thrift powers coupled with loose credit policies by a number of savings and loans, there was a rapid acceleration of losses in the industry. The employment growth rate of examination and supervisory personnel was outpaced by the increases in the industry's monetary growth rate. When oil prices plunged sending real estate prices into a downward spiral, savings and loans in the Southwest were left in a deeply depressed condition.

Mr. Chairman, the President's proposal seeks to stabilize the condition of the thrift industry until Congress adopts a sound course for its economic recovery. As is often the case when the Chairman of the Federal Reserve appears before this committee, we may have some disagreements on the size of the deficit and on certain economic assumptions. Today, however, Chairman Greenspan will urge us to increase Federal spending to solve this problem. For that reason alone, I'm sure that his testimony will be of interest to all of us.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator D'Amato.

Senator D'AMATO. Mr. Chairman, I would ask that I be permitted to submit my statement as if read in its entirety. I, too, have a hearing which I am chairing on the Subcommittee for Transportation and Appropriations. So I won't be able to be here.

I would make an observation that I am somewhat concerned about the requirements to bring up the capital requirements, to impose unrealistic burden. Obviously, we want greater capital in our thrifts, in particular, but to try to bring them up to the 6 percent level in 2 years I think could be very counterproductive. It is not realistic, and I am wondering if, Mr. Chairman, in the course of your testimony, you might touch on that.

The CHAIRMAN. Thank you, Senator D'Amato.

[The complete prepared statement of Senator D'Amato follows:]

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I welcome Chairman Greenspan for the second time this week. Today I am particularly anxious to hear the Fed Chairman's views on the capital requirements that have been proposed for thrifts. Clearly anyone who is aware of the history of the FSLIC deficit must wholeheartedly support increased capital requirements. I most certainly support the use of bright-line capital standards and risk-based capital requirements as a means of keeping both the banking and thrift industries out of trouble.

However, we are now embarking upon an uncharted course. The structure, standards and deadlines which we legislate will define the business environment in which healthy thrifts must compete with each other as well as other depository and mortgage lending institutions. The capital standards which the banks and thrifts of the post-crisis financial services industry must meet are the true survival tests. Free and open competition which is our constant goal carries with it the implication that some institutions will not survive the test of the capital markets. Our legislation must assure that the marketplace, not government, rules this survival test. Only then will we be assured of a self-sustaining, efficient home mortgage lending industry.

We must recognize that our current task is one of implementation. The higher capital standard is a sound concept. Risk weights in the risk-based capital rules and deadlines for achievement of capital standards, on the other hand, are the hands-on reality that the industry faces. These details of implementation will greatly influence the industry's long-term role in the financial services marketplace. Tuning these rules to achieve the goals of a sound, viable industry are the real challenge that government faces.

In Chairman Greenspan we have perhaps the one Government official with the most experience in the formulation of risk capital rules. Therefore, I look forward to his expert testimony on this and other significant topics.

Thank you, Mr. Chairman.

Senator Mack.

Senator MACK. Welcome back again, Mr. Greenspan.

I, too, am interested in the capital issue. Others have suggested rather than raising capital one of the ways to get the 6 percent is to reduce the size of the institution. I guess that is one alternative. I would be interested in your testimony this morning.

Thank you.

The CHAIRMAN. Thank you, Senator Mack.

Before we begin, I have a statement from Senator Sasser to be inserted in the record.

STATEMENT OF SENATOR JIM SASSER

Senator **Sasser**. Thank you, Mr. Chairman. I am pleased that today we will hear the comments of our Nation's leading financial regulator, Dr. Alan Greenspan, on the President's plan to rescue savings and loan depositors.

Dr. Greenspan has been much in the news of late mainly on the issue of inflation. Indeed, Dr. Greenspan seems to be giving every indication that he will force interest rates higher in response to the recent inflation data.

Yet we have to recognize that higher rates are going to raise havoc with the plan before us today. The President assumes that long term rates will drop significantly in the future—this is quite at odds with the view of Dr. Greenspan.

This divergence of opinion is important because higher interest rates are going to make the plan cost a lot more money. They'll make it much more expensive for the taxpayers.

Dr. Greenspan is certainly our expert on these matters. Yet it concerns me that the Fed had been clearly tightening the reigns now for 6 months—short term rates have gone up 50 percent in that time or 2.5 percentage points.

Now we have a 7.2 percent CPI number for January. This is cause for concern, but I am not convinced that we haven't already tightened enough to compensate for a 1 month inflation number like this. As Dr. Greenspan knows the effects of monetary fine tuning are not instantaneous.

So we have cause for concern about overtightening. The impact of even higher rates on the savings and loan crisis and the deficit could be devastating.

Mr. Chairman, in other areas, I am interested to see that Dr. Greenspan does appear to depart from the views of his predecessor on the need for a separate thrift industry. I look forward to delving into this later. Thank you, Mr. Chairman.

Chairman Greenspan, we would be pleased to hear from you now.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. **Greenspan**. Thank you very much, Mr. Chairman.

I am pleased to appear today before this committee to outline the views of the Federal Reserve Board on the legislation proposed by President Bush for the reform and recovery of the thrift industry. The Board supports this comprehensive package of proposals to strengthen the thrift industry, and depository institutions generally, as well as to prevent the serious problems of the thrift industry from recurring.

In addition to the legislative program, a number of administrative measures have been taken, or are planned as a first step to limit losses in insolvent institutions, more than 200 of them will be brought under Federal control in the next few weeks. As part of this effort, we are contributing 150 Federal Reserve examiners to the overall task force.

Moreover, to help attract responsible buyers for troubled thrifts, and as a result of the important changes in the environment for interstate banking, the Federal Reserve Board intends to reconsider the tandem operations restrictions on applications brought to the Board for acquisitions of failed or failing S&L's. In addition, we have made arrangements with the Federal Home Loan Banks and the FSLIC to support these basic sources of liquidity for the thrift industry.

I would like to focus my remarks today on the two major elements of the President's program: First, the restructuring and reform proposals and, second, the procedures for dealing with failed S&L's as well as the funding required to cover losses incurred by these institutions. Before turning to this task, I believe it would be useful to recall why we are facing a thrift problem and to draw some lessons from its causes.

CAUSES OF THE THRIFT PROBLEM

Today's thrift industry losses grew partly out of the vulnerability of a fixed rate, long-term, lender with relatively short-term liabilities, to changes in interest rates. As inflation and interest rates rose in the late 1970's and early 1980's, and as deposit rate ceilings were phased out, the resulting mismatch on the rising cost of deposit liabilities and the fixed return on mortgage assets produced substantial losses and a serious erosion of industry capital. Into this situation other elements were added. Expanded powers were mixed with inexperienced or dishonest management, brokered deposits that fed unchecked growth, lax accounting standards, seriously inadequate supervision, all within the context of adverse economic conditions. It is sobering how these factors led so quickly to insolvencies. In a short period, the serious but manageable maturity mismatch problem became a disastrous asset quality problem that we face today.

In evaluating this situation, I would not limit my emphasis, as some have done, to focusing only on the decline in regional economies and, in particular, on the drop in oil prices. The regional economic problems were real, but in assessing responsibility it is important to recognize that the oversupply in the real estate market in certain areas was at least partially a result of the lending by the S&L's themselves. During the period 1982 to 1985, in the face of declining oil prices, commercial real estate loans of savings and loan associations increased by more than $57 billion. That is more than double. In many cases these loans were made with an eye principally focused on front end fees, and without any reasonable assurance of repayment.

A comparison with the banking industry is instructive. While the banks do not have real estate equity investment powers, nonrecourse lending by banks for commercial real estate development projects with thin borrower equity positions often puts the bank lenders in a position where they are very close to equity investors. Taking this into account, it is all the more surprising that the estimated cost of resolving the thrift problems in Texas will run around $40 billion. In that State, where the economic environment for banks and thrifts is identical, the costs for resolving the problems of the banking industry, with assets that are much larger than those of the thrifts should amount to considerably less than

$10 billion. Clearly, the large absolute difference in costs, and the even larger differences in costs relative to assets, is evidence the thrift industry experienced a systems failure, that is, a major lapse in public and private prudential standards.

SUPERVISORY AND REGULATORY REFORMS

To deal with these problems, the new program focuses on the supervisory and regulatory reforms designed to ensure that the mistakes that have so adversely affected the thrift industry, its deposit insurance fund, and the taxpayers will not be repeated. A number of important steps have been proposed.

A new insurance fund for thrifts will be established to be administered by the FDIC, separately from the insurance fund for banks, but with special powers for the FDIC to approve applications by thrifts for insurance, make examinations, initiate enforcement actions, terminate insurance on an expedited basis, and prohibit thrifts from exercising powers that could cause undue risk to the FSLIC insurance fund.

Moreover, the proposal puts a new emphasis on adequate capital for the thrift industry as a cushion against losses and as a restraint on excessive risk taking. Accordingly, thrifts will be required to meet bank capital standards by June 1991, with the exception that they will be given 10 years to write off good will. For those institutions that do not meet the standard, growth can be restricted prior to the 1991 deadline, and must be prohibited after this time.

Our estimates indicate that more than a majority of the thrifts with positive tangible capital under GAAP standards could meet the existing bank primary capital requirements; on a risk-adjusted basis, we estimate that nearly two-thirds would meet bank standards, due largely to the favorable risk weight given to one to four family residential mortgages under the risk-based measure of capital.

If good will were to be immediately excluded from capital, the institutions falling below the standard would have to raise about $15-$20 billion in capital to meet bank minimums. However, the proposed legislation, as noted, gives thrifts a 10-year period to write off the good will; thus, this major capital raising effort can be spread over a number of years.

It should be emphasized that if losses continue or accelerate due to further credit deterioration or interest rate exposure, the industry's need for capital could be substantial. Those institutions that cannot meet bank capital standards as set forth in the proposed legislation would necessarily have their growth restricted or may be required to shrink their assets.

The administration's program also takes major steps towards restructuring the thrift supervisory and regulatory framework.

First, a new, more independent thrift regulator, second, reconstituted boards of directors of the Federal Home Loan Banks and, third, a requirement that thrifts that do not devote a majority of their resources to housing must become banks.

Another important part of the reform package is the increase in insurance premiums for both thrifts and banks, as well as the authority for the FDIC to raise premiums for both types of institutions in the light of experience.

The proposed premium increase for banks stands on its own merits, quite apart from anything that might be done about thrifts, as a necessary step to maintain the integrity of the FDIC fund against future contingencies.

RESOLUTION TRUST CORPORATION

Another element of the President's program is a funding package designed to provide sufficient financial resources to resolve current and prospective insolvencies among FSLIC-insured institutions. This function would be assigned to a newly created Resolution Trust Corporation [RTC], to be managed by the FDIC and operated under the direction of the Oversight Board composed of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, and the Attorney General. To accomplish its task, the RTC would be provided with $50 billion of funding—the proceeds of bonds issued by RTC Funding Corporation. These funds would be used to resolve insolvent thrifts that have not received assistance from FSLIC or which will become insolvent over the next 3 years. Principal would be repaid with the proceeds of zero coupon bonds purchased from thrift industry resources, and the interest on the bonds would be paid with thrift industry and, if necessary, Treasury funds.

The most recent data available indicate that about 470 thrifts, with assets of around $250 billion, are tangible capital insolvent. It seems prudent to assume that all of these institutions will require RTC assistance. We cannot know exactly what the resolution costs will be for these institutions, but based on FSLIC's estimates of the costs of its 1988 resolutions, we estimate that it will cost around $40 billion to take care of these 470 institutions. Of course, many other FSLIC-insured institutions are at present thinly capitalized and some of these could well become insolvent during the 3-year period for which RTC would be responsible for new insolvencies.

We have looked at the cost of resolving new and existing insolvencies under different scenarios, and under some, unlikely, circumstances the resolution costs could exceed $50 billion. However, in our judgment, all things considered, the $50 billion should be adequate. There is, of course, much that is unknown, and that is now unknowable, that will affect this judgment. Marginal adjustments may be necessary as experience is gained to take account of, for example, additional costs or recoveries. The critical point is that the fundamental approach is sound, and has the necessary flexibility to adapt to changes in circumstances.

Key to the RTC's ability to minimize costs is flexibility to pursue various resolution options. Such flexibility would permit the separate marketing of franchises and troubled real estate portfolios, which might broaden the market and thereby increase the values of both. In particular, in cases where no franchise value remains in an organization, the least cost option would likely be liquidation rather than purchase and assumption. To reduce overall costs, the RTC must have the resources necessary to pursue this course.

The Federal Reserve Board attaches considerable importance to the provision of the proposed legislation that calls for the Secretary of the Treasury, in conjunction with the Federal financial regulators, to undertake a study of the nation's deposit insurance system. There are major areas of concern about the system, focusing on its apparent bias toward excessive risk-taking, its tendency in the direction of differential treatment of small and large institutions, and the unintended expansion of insurance coverage through such techniques as brokering deposits that have been disaggregated into $100,000 segments.

A review, at both a conceptual and practical level, is needed of the consistency of an insurance system that evolved out of the Great Depression, on the one hand, with today's deposit gathering industry of both small banks and giant modern financial services organizations that operate across markets and national boundaries, on the other. It will be no easy task. It must be done carefully and the recommendations implemented gradually to ensure a smooth transition to modified insurance arrangements.

Mr. Chairman, I would like to close my testimony by stressing that it is vitally important for Congress to move very promptly to consider and enact the President's proposals. We must make available the resources the regulators need to close insolvent thrifts. We must stop the continuing daily losses due to operating expenses that greatly exceed income as well as to the higher than normal rates that they must offer to attract deposits. In operating in this way, they not only hurt themselves and the insurance funds, but as they drive up rates they also injure their competitors and the economy as a whole. Prompt action is essential to maintain public confidence in thrift institutions and their insurance funds.

Thank you very much.

[The complete prepared statement of Alan Greenspan follows:]

For release on delivery
10:00 a.m., E.S.T.
February 23, 1989

Statement by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

of the

U.S. Senate

February 23, 1989

I am pleased to appear today before this Committee to outline the views of the Board of Governors on the legislation proposed by President Bush for the reform and recovery of the thrift industry. The Board supports this comprehensive package of proposals to strengthen the thrift industry, and depository institutions generally, as well as to prevent the serious problems of the thrift industry from recurring.

The proposals in the bill include:

- greatly enhanced supervisory, regulatory and enforcement authority,
- a new framework for resolving insolvent thrift institutions,
- a separate insurance fund for thrifts under the administration of the FDIC, and
- a strengthening of this new thrift fund, as well as the FDIC fund, through higher premiums.

In addition to this legislative program, a number of administrative measures have been taken, or are planned. As a first step to limit losses in insolvent institutions, more than 200 of them will be brought under federal control in the next few weeks. As part of this effort, we are contributing 150 Federal Reserve examiners to the overall task force.

Moreover, to help attract responsible buyers for troubled thrifts, and as a result of the important changes in the environment for interstate banking, the Federal Reserve Board intends to reconsider the tandem operations restrictions on applications brought to the Board for acquisitions of failed or failing S&Ls. In addition, we have made arrangements with the Federal Home Loan Banks and the FSLIC to support these basic sources of liquidity for the thrift industry.

I would like to focus my remarks today on the two major elements of the President's program: (a) the restructuring and reform proposals, and (b) the procedures for dealing with failed S&Ls as well as the funding required to cover losses incurred by these institutions. Before turning to this task, I believe it would be useful to recall why we are facing a thrift problem and to draw some lessons from its causes.

Today's thrift industry losses grew partly out of the vulnerability of a fixed rate, long-term, lender with relatively short-term liabilities, to changes in interest rates. As inflation, and interest rates, rose in the late 1970's and early 1980's, and as deposit rate ceilings were phased out, the resulting mismatch on the rising cost of deposit liabilities and the fixed return on mortgage assets produced substantial losses and a serious erosion of industry capital. Into this situation other elements were added. Expanded powers were mixed with inexperienced or dishonest management, brokered deposits that fed unchecked growth, lax accounting standards, seriously inadequate supervision, all within the context of adverse economic conditions. It is sobering how these factors led so quickly to insolvencies. In a short period, the serious, but manageable, maturity mismatch problem became the disastrous asset quality problem that we face today.

In evaluating this situation, I would not limit my emphasis, as some have done, to focusing only on the decline in regional economies and, in particular, on the drop in oil prices. The regional economic problems were real, but in assessing responsibility it is important to recognize that the oversupply in the real estate market in certain areas was at least partially a result of the lending by the S&Ls themselves. During the period 1982 to 1985, in the face of declining oil prices, commercial real estate loans of savings and loan associations increased by more than $57 billion (129%). In many cases these loans were made with an eye principally focused on front end fees, and without any reasonable assurance of repayment.

A comparison with the banking industry is instructive. While the banks do not have real estate equity investment powers, non-recourse lending by banks for commercial real estate development projects with thin borrower equity positions often puts the bank lenders in a position where they are very close to equity investors. Taking this into account, it is all the more surprising that the estimated cost of resolving the thrift problems in Texas will run around $40 billion. In that state, where the economic environment for banks and thrifts is identical, the costs for resolving the problems of the banking industry, with assets that are much larger than those of the thrifts, should amount to considerably less than $10 billion. Clearly, the large absolute difference in costs, and the even larger difference in costs relative to assets, is evidence the thrift industry experienced a systems failure, that is, a major lapse in public and private prudential standards.

To deal with these problems, the new program focuses on the supervisory and regulatory reforms designed to ensure that the mistakes that have so adversely affected the thrift industry, its deposit insurance fund, and the taxpayers will not be repeated. A number of important steps have been proposed.

A new insurance fund for thrifts will be established to be administered by the FDIC, separately from the insurance fund for banks, but with special powers for the FDIC to

approve applications by thrifts for insurance, make examinations, initiate enforcement actions, terminate insurance on an expedited basis, and prohibit thrifts from exercising powers that could cause undue risk to the FSLIC insurance fund.

Moreover, the proposal puts a new emphasis on adequate capital for the thrift industry as a cushion against losses and as a restraint on excessive risk-taking. Accordingly, thrifts will be required to meet bank capital standards by June 1991, with the exception that they will be given 10 years to write off goodwill. For those institutions that do not meet this standard, growth can be restricted prior to the 1991 deadline, and must be prohibited after this time.

Our estimates indicate that more than a majority of the thrifts with positive tangible capital under GAAP standards could meet the existing bank primary capital requirements; on a risk-adjusted basis, we estimate that nearly two-thirds would meet bank standards due largely to the favorable risk-weight given to 1-4 family residential mortgages under the risk-based measure of capital.

If goodwill were to be immediately excluded from capital, the institutions falling below the standard would have to raise about $15-20 billion in capital to meet bank minimums. However, the proposed legislation, as noted, gives thrifts a 10-year period to write off the goodwill; thus, this major capital-raising effort can be spread over a number of years.

It should be emphasized that if losses continue or accelerate due to further credit deterioration or interest rate exposure, the industry's need for capital could be substantial. Those institutions that cannot meet bank capital standards as set forth in the proposed legislation would necessarily have their growth restricted or may be required to shrink their assets.

The Administration's program also takes major steps toward restructuring the thrift supervisory and regulatory framework. In addition to separating the insurance and regulatory functions, the proposal would create a new federal thrift regulator. The new regulator -- the Chairman of the Federal Home Loan Bank System (FHLBS), who would be under the Secretary of the Treasury in the same relationship as the Comptroller of the Currency -- should be more independent from the industry. Importantly, the FHLBS would be required to apply bank supervisory and accounting standards to the S&Ls.

Moreover, the boards of directors of the Federal Home Loan Banks will be reconstituted along the lines of Federal Reserve Bank boards. This should make them more responsive to the broader public interest. In contrast to present arrangements, most of the membership of the Boards will be drawn from outside the industry, including the Chairman and Vice Chairman of the boards, who will be chosen by the new chief of the Federal Home Loan Bank System. Finally, the Chairman of the FHLBS, as the new regulator and supervisor, would carry a mandate emphasizing safety and soundness, and would appoint the head supervisory agent at the Home Loan Banks who would be directly responsible to the FHLBS in Washington. These are both necessary and important reforms.

Another step recommended by the President, to which we attach great importance, is the requirement that savings and loans that do not meet the qualified thrift lender (QTL) test (60 percent of assets in residential-related lending) in the Competitive Equality Banking Act of 1987 must, after an appropriate transition period, become banks and be subject to the entire regulatory and supervisory regime applicable to banks and their holding companies. We believe it is fully appropriate to confine the benefits of thrift status, involving both access to subsidized long-term borrowing from Federal Home Loan Banks and tax benefits, to only those institutions that devote a major part of their assets to promoting home ownership.

Another important part of the reform package is the increase in insurance premiums for both thrifts and banks, as well as the authority for the FDIC to raise premiums for both types of institutions in the light of experience. For thrifts, where the fund is now insolvent and in need of rebuilding, premiums under the proposal will rise in 1990 from their present level of 20.8 basis points to 23 basis points in 1991, remain at that level for 3 years, and then fall to 18 basis points in 1994.

For banks the current premium of 8 basis points would increase 4 basis points in 1990, and another 3 in 1991; and then would be held at that level. However, when the insurance funds reach the target for reserves of 1.25 percent of insured deposits, rebates would again be possible.

The level of FDIC insurance reserves as a percentage of insured deposits has dropped in recent years to the present ratio of 0.83 percent, and it is important that this trend be reversed. The proposed premium increase for banks thus stands on its own merits, quite apart from anything that might be done about thrifts, as a necessary step to maintain the integrity of the FDIC fund against future contingencies.

Another element of the President's program is a funding package designed to provide sufficient financial resources to resolve current and prospective insolvencies among FSLIC-insured institutions. This function would be assigned to a

newly created Resolution Trust Corporation (RTC), which would be managed by the FDIC and operate under the direction of the Oversight Board composed of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, and the Attorney General. To accomplish its task, the RTC would be provided with $50 billion of funding -- the proceeds of bonds issued by a RTC Funding Corporation. These funds would be used to resolve insolvent thrifts that have not received assistance from FSLIC or which will become insolvent over the next three years. Principal would be repaid with the proceeds of zero coupon bonds purchased from thrift industry resources, and the interest on the bonds would be paid with thrift industry and, if necessary, Treasury funds.

The most recent data available (for September 30, 1988) indicate that about 470 thrifts, with assets of around $250 billion, are tangible capital insolvent. It seems prudent to assume that all of these institutions will require RTC assistance. We cannot know exactly what the resolution costs will be for these institutions, but based on FSLIC's estimates of the costs of its 1988 resolutions we estimate that it will cost around $40 billion to take care of these 470 institutions. Of course, many other FSLIC-insured institutions are at present thinly capitalized and some of these could well become insolvent during the three-year period for which RTC would be responsible for new insolvencies.

We have looked at the cost of resolving new and existing insolvencies under different scenarios, and under some, unlikely, circumstances the resolution costs could exceed $50 billion. However, in our judgment, all things considered, the $50 billion should be adequate. There is, of course, much that is unknown, and that is now unknowable, that will affect this judgment. Marginal adjustments may be necessary as experience is gained to take account of, for example, additional costs or recoveries. The critical point is that the fundamental approach is sound, and has the necessary flexibility to adapt to changes in circumstances.

Key to the RTC's ability to minimize costs is flexibility to pursue various resolution options. Such flexibility would permit the separate marketing of franchises and troubled real estate portfolios, which might broaden the market and thereby increase the values of both. In particular, in cases where no franchise value remains in an organization, the least-cost option would likely be liquidation rather than purchase and assumption. To reduce overall costs, the RTC must have the resources necessary to pursue this course.

When so much money is needed to make up for such large losses, partly from mismanagement, and in no small part due to fraud, is it reasonable to ask the taxpayers to pay any part of these costs?

It is. The basis for my answer goes far beyond the Congressional pledge of the full faith and credit of the United States behind insured deposits. The reason for public expenditure to support deposit insurance is the basic benefits to the economy as a whole that we derive from deposit insurance. The certainty and stability provided by deposit insurance benefits the nation as a whole, while it protects the individual from catastrophic loss. By giving the public confidence in the safety of its funds we avoid the deposit withdrawal and losses that disrupted the payments system and the savings and investment process in the 1930s. Losses of the kind that we face today should not happen, but with the gains to society as a whole that come with deposit insurance we must accept both the possibility and the reality that there will be losses to be borne by society as a whole.

Our job now is not to see to it that there are never any losses as a result of deposit insurance; to do so would require limitations and rules that would put depository institutions lenders, and the economy they serve, in a straight-jacket. Such a course would be costly to growth and efficiency. Our task is to see to it that the potential for losses is minimized to the extent possible, and that steps are taken to ensure that the preventable governmental, regulatory, supervisory and human failures that were the cause of the thrift industry losses do not happen again.

The Board attaches considerable importance to the provision of the proposed legislation that calls for the Secretary of the Treasury, in conjunction with the federal financial regulators, to undertake a study of the nation's deposit insurance system. There are major areas of concern about the system, focusing on its apparent bias toward excessive risk-taking, its tendency in the direction of differential treatment of small and large institutions, and the unintended expansion of insurance coverage through such techniques as brokering deposits that have been disaggregated into $100,000 segments.

A review, at both a conceptual and practical level, is needed of the consistency of an insurance system that evolved out of the Great Depression, on the one hand, with today's deposit-gathering industry of both small banks and giant modern financial services organizations that operate across markets and national boundaries, on the other. It will be no easy task. It must be done carefully and the recommendations implemented gradually to ensure a smooth transition to modified insurance arrangements.

Without in any way meaning to pre-judge the conclusions of the study I would like to discuss several matters that should receive attention.

First, I would note that all analyses of which I am aware have suggested that depositors are not effective at restraining imprudence or risk-taking at banks and thrifts. They cannot be expected to have sufficient information, and tend, in any event, to be either unresponsive or to run when faced with bad news. If the study confirms that view, the policy options that then must be seriously considered surely will include other ways to limit risk-taking, such as enhanced supervision, different insurance assessment techniques, or use of subordinated capital that would not be protected in case of failure. The large cost to the public of the legislation before you suggests that we must consider the potential benefits of requiring prompt recapitalization, merger, or closure of troubled insured entities whose capital is declining but still positive.

Second, attention should be given to determining whether specialized fixed rate residential lending institutions are needed today. This question is raised because of the costs and competitive distortions involved in subsidized borrowing from Home Loan Banks, the dangers inherent in special regulatory and supervisory regimes for subsidized depository institutions, and the continued vulnerability of a large element of the thrift industry to increased interest rates.

This question should also be considered because of the important changes in the mortgage market. In the past, home mortgages were a uniquely local product, almost always held to maturity by the original lender. Now, computers, modern telecommunications and financial engineering have vastly changed this market. In today's market, mortgages frequently are originated by a wide variety of intermediaries, bundled into securitized products, and sold to institutional investors in all parts of the country -- more than one-third of outstanding home mortgages are held in securitized form. This new environment may make it unnecessary to provide special government subsidized facilities for mortgage lending, and may make it possible to eventually bring all depository institutions under one regulatory and supervisory system. This issue should be given priority attention as part of the study of deposit insurance reform.

Third, in considering the reforms that should be developed, considerable attention has been focused on the expanded investment and lending powers that have been granted to state chartered thrifts. The study must examine the safeguards that should be developed for the future.

These safeguards should not require rigid prohibitions on types of activities that may be engaged in by depository institutions. Rather, as a first step, consideration should be given to requiring that non-banking activities of banks and thrifts take place in subsidiaries of holding companies to ensure that these activities are not subsidized by the federal safety net, and that this safety net will not be responsible for covering any losses that may arise from these non-banking activities. We have such a proposal under review at the Board. In addition, consideration should be given to amending and expanding existing law to limit risky non-banking activities in banks and thrifts.

* * *

I would like to close my testimony by stressing that it is vitally important for Congress to move very promptly to consider and enact the President's proposals. We must make available the resources the regulators need to close insolvent thrifts. We must stop the continuing daily losses due to operating expenses that greatly exceed income, as well as to the higher than normal rates that they must offer to attract deposits. In operating in this way, they not only hurt themselves and the insurance funds, but, as they drive up rates, they also injure their competitors and the economy as a whole. Prompt action is essential to maintaining public confidence in thrift institutions and their insurance fund.

The CHAIRMAN. Thank you, Mr. Chairman.

If I may, before proceeding, I would like to ask you at this time to go back to page 11 of your statement.

Do you have the full text of your prepared statement?

I know you were summarizing as you were going, and so you read part of your testimony and omitted other parts.

The first two paragraphs on page 11 because they really relate importantly to a series of questions that have arisen, and I think you are the person that needs to be heard on this. If you have no objection. I would just ask you if you would mind delivering that part of your testimony.

Mr. GREENSPAN. By all means.

When so much money is needed to make up for such large losses, partly from mismanagement, and in no small part due to fraud, is it reasonable to ask the taxpayers to pay any part of these costs?

In my judgment, it is. The basis for my answer goes far beyond the congressional pledge of the full faith and credit of the United States behind insured deposits. The reason for public expenditure to support deposit insurance is the basic benefits to the economy as a whole that we derive from deposit insurance. The certainty and stability provided by deposit insurance benefits the Nation as a whole, while it protects the individual from catastrophic loss. By giving the public confidence in the safety of its funds, we avoid the deposit withdrawal and losses that disrupted the payments system and the savings and investment process in the 1930's. Losses of the kind that we face today should not happen, but with the gains to society as a whole that come with deposit insurance, we must accept both the possibility and the reality that there will be losses to be borne by society as a whole.

The CHAIRMAN. Thank you. I thought that was an important part of your statement, and we want to have it out here today.

We have had three other members arrive who have been attending other committee sessions, and at this point I am going to just briefly call on each for any opening comment they want to make before we proceed to questions.

Senator Bryan.

Senator BRYAN. Mr. Chairman, I would like to reserve my time for the questions portion.

The CHAIRMAN. Thank you.

Senator Graham.

Senator GRAHAM. Mr. Chairman, thank you. I would also like to reserve my time.

The CHAIRMAN. Very good.

Senator Wirth.

Senator WIRTH. Thank you, Mr. Chairman. No statement.

The CHAIRMAN. I know most of your comments here today are addressed to the structural changes, and we will get to that. Let me ask you this first, Chairman Greenspan. There is a lot of controversy about the cost of the program.

Has the Fed done the work or have you had a chance to make a judgment yourself as to what this package will cost over different time periods, whether it be the first 10 years or the full 30 years?

COST OF THE PROGRAM

Mr. **Greenspan**. We have basically endeavored to try to come up with different scenarios and different cost estimates as a consequence, and what we find is that an overall net cost of the FSLIC crisis, as we like to call it, of $90 billion is not an unreasonable number.

Let me explain precisely what that number is because I think one of the reasons we have been having trouble with numbers in the last several weeks is that there are several concepts that have to be clarified.

What I would like to do is to recognize that when we talk about the $90 billion hole, what we are essentially saying is what would it cost to fill that hole finally and put everything back in place.

Now, what that number is, if you take the $40 billion that presumably has been expended up to now, is say roughly $50 billion up front. Now, if we, for example, had full taxpayer funds up front and had no interest costs involved in that—just put the funds in and it was a done deal—that would end it. We are not choosing to do that. We are choosing to set up various types of funds, various types of borrowings, and they generate interest.

Adding interest in this context as a cost is inappropriate because that would stipulate that any borrowing should be measured not in terms of its principal but also in terms of its interest.

In this particular context I think it is confusing to have the interest on top of the principal, since what we are doing is borrowing the resources and paying interest on them, but the resources that we borrow is what the hole is, and that is the appropriate measure.

I hope that is clear. I suspect it probably is not, but I will keep trying.

The **Chairman**. Please continue.

Mr. **Greenspan**. Second, there is another technical problem which is involved in all of these calculations, and if the committee is having difficulty in trying to get its hands around a set of numbers, it should be, because this is a very complex conceptual/numerical analysis.

Accountants, insurance people, and economists have a concept called present value, and that is an endeavor to say what basically will something cost over a period of years if I just put all of the money up front, let it earn interest, and use both the interest and the principal to pay off the amounts of money.

Let me give you a case in point—the difference between, say, borrowing on budget and borrowing off budget. Let's assume we use a figure of 25 or 30 basis points. That aggregate over a 30-year period, is $3 or $4 billion, but it really is only $1 billion, or a little more than that, because if you had $1 billion today and put it in a bank you would generate enough money to make up that gap so that the present cost is not the $3 or $4 billion. It is the $1 billion.

The reason I raise this issue is I think you will be seeing through these hearings and through your evaluations an intermixing of all of these concepts. That is the reason why there is a difficulty in coming to grips with the issue of what does this all cost.

Now, having said all that, having gone through all of this ourselves, I think another very important issue has to be understood, and that is there is no way to come up with an exact number at this particular stage on what it is going to cost and exactly how much funding is going to be required, but you don't need that.

What you basically need is a general approach, such as the administration's, which, in our judgment, probably will turn out to be pretty much what will resolve this problem for once and for all.

It is, however, conceivable that there may be a minor midcourse correction required a year or two from now. I would not view this as something in which the Congress makes a judgment, commits funds, and then goes on to other business and says I will never look at this again.

This is the type of problem in which what one has to do, in a sense, is to get the rocket in orbit and then worry about the fine-tuning later. You may in fact need a minor midcourse correction, but, in our judgment, having looked through all the numbers that the Treasury put together, looking at different interest rate assumptions, looking at different funding assumptions, it is the judgment of the Federal Reserve Board that this is an appropriate approach, in fact a quite reasonable approach to resolve this question and, in our judgment, we fully support it for that reason.

We do not believe that there is an alternative program, at least that we have seen, which will turn out to be superior to this.

The CHAIRMAN. Thank you. This is an extraordinarily complex question and issue. So I am sensitive to the time that it takes for you to give a full answer.

I will only add one thought before yielding to Senator Garn. That is that you explained well the discounted present value idea in terms of how we look at costs today versus expenditures that we are locked into making in the future.

On the other hand, I think it is fair to say that the public would view it differently. They will be obligated to a whole series of payments in the future that are locked in—payments to be made next year, the year after, the year after that, and so forth. While you can go through a discounting process, they will still feel, I think with some justification, that they are obligated to pay that many dollars going out in time.

There are a whole stream of obligations that in fact the Government will have to meet. So there is another way of adding up the costs, and there is some relevance, I think, to that measure, quite apart from the discounted cash flow way of looking at it.

We will want to come back to that. I know other members have a keen interest in that, but to keep it moving let me yield now to Senator Garn.

Senator GARN. Thank you, Senator Riegle.

Mr. Chairman, I think you have made an extremely good point that often seems to be lost in the debate that has been going on now for over 3 years—when I started trying with the administration to get a $15 billion FSLIC recap passed 3 years ago and the House of Representatives was not willing to go along.

I certainly would not suggest that if we had approved that that the problem would have gone away, but I will guarantee that it would have been much, much smaller because a lot of institutions would have been closed down and would not have been allowed to grow over a long period of time.

At that time we were talking about a hemorrhaging of $6 million a day. That was $180 million a month. Now, we are talking $½ billion to $1 billion a month.

But I say you made a good point. I wish more people would listen to that.

We spend so much time debating what the size of the problem is and arguing about it and testifying about it and trying to come up with it. First of all, it is impossible—I agree with you—to come up with an accurate number. What is important is that we start on a solution. If we had started on a solution in 1986, we wouldn't be debating $100 billion, $127 billion, $133 billion.

If this Congress doesn't act quickly on a solution rather than continuing to be so concerned about whether it is $10 billion more or $10 billion less, it is going to be $200 billion. We will guarantee a self-fulfilling prophecy, and the major reason it is so large today is because of the inaction of Congress, and particularly the House of Representatives.

I would hope that would not be lost. That is why I am so pleased and every day compliment the chairman on how rapidly he is moving with this. That is the important thing, to get a plan into effect.

If we have to make a midcourse correction, I know something about that. We can in the future, but we need a plan in place to stop the hemorrhaging, to make the reforms and get these institutions that are hemorrhaging out of business so that we minimize the losses in the future, or some future committee will be sitting here debating a much bigger bailout plan.

So my advice is let's talk about solutions, which you are doing and others are doing, rather than arguing about the size of the problem because the longer we wait the bigger the problem will become.

There are a lot of people—you have and I have criticized the actions of certain States, and there is no doubt that the majority of the S&L's that have been in trouble and are in trouble are State-chartered institutions allowed powers beyond what Federal charters allow them, and we had discussion from some who would simply say that anything that a State does is fine, but if they want Federal insurance all of their State powers will be prohibited.

So what I am driving at is the value of the dual banking system and also how do we preserve some innovation—NOW accounts, adjustable rate mortgages. There are a lot of things that have come from State-chartered institutions or State powers that were way ahead of the feds.

Do you have any advice for us on how we can stop the abuses of the State-chartered institutions and legislatures that go too far without throwing the baby out with the bath water and inhibiting a lot of good ideas that have come from State institutions?

STOPPING ABUSES BY STATE-CHARTERED INSTITUTIONS

Mr. **Greenspan**. Senator, we for a long time always argued that one way of doing it—there are a number of ways to combat this—is essentially to require that State-chartered institutions which take on activities beyond those allowed under Federal charters, be placed in a separate subsidiary, either of the thrift or preferably of a holding company should a holding company exist for that thrift.

Senator GARN. Similar to what we did in S. 1886 last year for banks?

Mr. GREENSPAN. Yes. There are other ways of doing it, but I do think it is something we should be concerned about because clearly there is a question of Federal insurance being initiated by other than Federal authorities, and it is a central problem.

Senator GARN. Let me ask you another question that came up yesterday. There was a good deal of discussion about the new capital requirements for S&L's to be obtained by 1991, and the discussion was going along as if there were a cliff to fall off in 1991. Those institutions that didn't meet the capital requirements would be closed down.

That is not my understanding of the plan. Obviously, you'll have had some that were increasing their capital but did not make the 6-percent by that period of time. And they would have had some growth limits placed on them, some restrictions, until they obtained that capital.

But is that your understanding, being part of the team making these recommendations, that there is no sharp cliff to fall off; there is a means of working with them?

Mr. GREENSPAN. That is correct, Senator.

I think any institution prior to 1991 which falls short of bank capital requirements would have its growth restricted. Subsequent to that, it would have its growth terminated.

By that I mean not that the institution is liquidated, but that its assets could no longer grow. It would still be a solvent institution with inhibited growth, and it could in that process gradually meet its capital requirements, after which it would then be allowed to come out from under the cap and to grow.

There is no need to liquidate unless some institution decides that it feels too restricted under those conditions, in which case it probably would voluntarily liquidate, but that is a business decision. That is not a regulatory decision.

Senator GARN. I appreciate that explanation. Treasury did not make that clear yesterday.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

I am going to just ask for a clarification on a point that I understood you to make in response to Senator Garn.

Is it your view, then, that in regard to expanded State powers that go beyond the Federal charter for savings and loans, we ought to prevent deposits directly backed by Federal deposit insurance from being used in such activities?

Mr. GREENSPAN. I think it should be considered. I think that at this particular stage the powers of the FDIC as proposed in the legislation that is before you would effectively oversee, and presumably restrain, the powers from becoming a burden on the Federal insurance funds.

However, I am merely reiterating a position that the Federal Reserve has held for a long period of time. It is not explicitly part of the administration's proposal.

Let me say this about the administration's proposal. I think in total it is a highly desirable bill to pass, and I would pass it in total. We all have differing views when any compromises are made among institutions such as the Federal Reserve, the Treasury, and others, about how one would put together a specific regulatory structure.

The proposals of the Treasury encompass essentially the outcome of discussions among a number of the regulatory agencies, and I would just as soon support what we all agree to rather than say I will support only those things which I originally felt were the Federal Reserve's idea.

So I don't want to indicate to you that since we have had a position which differs just modestly from what is proposed that we are in a sense pushing that because we are not.

I am just merely indicating what our own historic position has been. But we find the Treasury's recommendation in this regard perfectly acceptable.

The CHAIRMAN. We will come back to that later.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman Greenspan, you have used the word that this is a reasonable approach to the thrift crisis.

PROBABLE MIDCOURSE CORRECTION

Could we read in there after you also used the term that we might have to come back, we might not, for a midcourse correction—would this be only the beginning of this crisis and we will have to adjust our numbers and our money, of course, coming from the numbers as the situation develops and we don't really know what is going to develop out there in the next 5, 6, 7 years?

Mr. GREENSPAN. Yes. I have stated it on both sides. It is quite conceivable that the Treasury's recommendations will overfund the problem.

What I am saying is that anyone who thinks that they are going to make a forecast about the American economy over the next 10 years down to the final decimal point and calculate precisely how that will translate into what the U.S. Government's full faith and credit obligation on that deposit system turns out to be has got insights that are not being vouchsafed to the remainder of the human race.

Senator SHELBY. You haven't seen them in all your years as an economist, have you, anybody that could vouchsafe anything like that?

Mr. GREENSPAN. No, and I think the important point, Senator, is that we don't need to.

At the moment we know that the full faith and credit of the U.S. Government is behind these deposits. The obligation is already there. The problem is how is that best disposed of.

You don't need to know at this stage what the final number is because even if you knew it, it wouldn't help because you would still have to go through a series of actions, and if you turn out to be exactly right at the end that is terrific and they will give you a cigar, but you don't need it.

What you do need, however, is to get there approximately so that this Congress does not have to revisit another crisis. What I am saying is the crisis can be ended here and now. It will require almost surely some adjustments later, and as I said, it may be a reduction in the amount required, but I would not shy away from that because I think that is built into the nature of the process.

Senator SHELBY. Basically, any kind of approach like this would be a flexible approach, depending on what came up in the outyears, good or bad?

Mr. GREENSPAN. Exactly.

Senator SHELBY. Chairman Greenspan, let me get into the basic origination of home mortgages by a lot of the thrifts. I understand that they currently originate about 54 percent of the home mortgages, but that they only hold about 35 percent of the mortgage debt outstanding.

Of course, we both realize that securitization of mortgages has changed the role of the thrifts in this regard.

My basic question to you, will securitization as it continues to grow eliminate the need for separately chartered and separately regulated thrift institutions?

Mr. GREENSPAN. Senator, we don't know the answer to that question. What we do know is that irrespective of what you charter or what you don't charter, there will nonetheless be a number of depository institutions in the future which, because of their expertise in mortgage origination, servicing, and funding, will be highly profitable and will choose to have that form of balance sheet, wholly independently of what the regulatory structure is, what the tax structure is, and whatever else we do.

There is no question that in recent years the onset of securitization has changed the nature of the mortgage instruments. I think they have become major assets in the American financial system; that is, the spread between them and U.S. Treasuries, for example, is remarkably stable and even closer in certain respects than between them and single A corporate rated bonds.

So securitized mortgages have become almost, but not quite, a fully seasoned security in the system. That is extraordinarily important to make sure that we have got the basis of housing finance.

What thrifts can do, which no one else can do as well, is mortgage origination. They know the local area. They know the people with whom they are dealing, and they have and will continue to have, if they so choose, the majority of the originations or close to it relative to other institutions.

Servicing has come down a bit. There is a number of other institutions that have decided to go into that, but I am not sure I know the trends in that.

I do think that we ought to review the whole structure, not because I think it will be changed, but I think we will be a lot better off if we have reviewed it.

Senator SHELBY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Shelby.

Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Mr. Chairman, yesterday when Secretary Brady testified before this committee he stated on page 12 of his testimony, and I quote:

The administration's plan is designed explicitly to promote housing finance by revitalizing the savings and loan industry and the Federal Home Loan Bank System.

In your testimony today, pages 13 and 14, which I alluded to in my earlier remarks, you give four reasons why there should not be a separate thrift industry.

STUDY OF THRIFT INDUSTRY FOR CHANGES IN THE SYSTEM

Mr. GREENSPAN. I gave you four reasons that have been raised as to why there should not.

That is not what I am saying. I am saying they should be studied. I am not arguing at this stage that we should do away with the thrift industry. On the contrary, what I am saying is we ought to review the system to capture what has changed fundamentally in the system because I do not believe that the long term fixed rate mortgage financed by short term liabilities is a viable financial entity.

Senator HEINZ. If you believe those issues should be studied, do you believe it is wise for Congress to pass a plan that is explicitly designed to strengthen, institutionalize, perpetuate, and otherwise promote exactly that which you say should be studied, with a view perhaps toward its elimination?

Mr. GREENSPAN. No, because I don't think that the issue is the elimination.

Senator HEINZ. No, we should not pass legislation?

Mr. GREENSPAN. No, I am sorry. I love the way you debate. [Laughter.]

Senator HEINZ. I don't want either of us to get in trouble.

Mr. GREENSPAN. I was hoping I could phrase my way out of that. I think the original concept of the thrift institution was the fixed rate mortgage financed by short-term liabilities. We have learned that that is not a viable institution.

We have also learned that the nature of any depository institution has to change. The adjustable rate mortgages have been a crucial change in the structure of thrift institutions, and if we didn't have them, I would say we probably would not have viable thrifts today.

What I think we had better do is to really take an overall look at this system and review it for the longer-term.

There is nothing in this legislation that is being proposed which, in my judgment, would in any way be required to be altered because I don't think that the end result of a study is going to say we should have no thrifts. On the contrary, I think we will conclude at the end of that study that there should be recommendations to modernize the structure and to certify the changes that are already underway and have occurred in the last decade or so.

There is nothing in this legislation which, in my judgment, alters that. In other words, the regulatory structure, no matter how you come out on any of these other questions, and what it is that is being requested by the administration as far as I am concerned is not the issue that has to be studied.

I just think that what has to be studied is how to make sure that we find ways, for example, of creating instruments in savings and loans where liabilities can be lengthened. Even though we have had adjustable rate mortgages and a significant increase in short-term assets in the thrifts, we still fundamentally have got the remnants of that maturity mismatch that created all of the basic problems, and that still has to be resolved.

That, I think, has to be studied, and, if we can figure out a way to do it, that will lead to recommendations that can be evaluated against the basic type of institutional and technological changes that are occurring.

My own judgment is that at the end of the day thrifts will look a good deal more like banks than they do at this particular stage, but they will still be thrifts.

Senator HEINZ. You have raised a fascinating issue, which may be tangential to what we are talking about, but I am absolutely fascinated and immensely curious about how you would do anything that would lengthen the liabilities.

Mr. GREENSPAN. Such as—and I am not saying——

Senator HEINZ. Hypothetically.

Mr. GREENSPAN. The trouble, unfortunately, is you start listing things and they think you are recommending them.

Senator HEINZ. With that understanding, please list them.

Mr. GREENSPAN. I can give you lots of reasons why these are problems because they are expensive. For example, we could have 5-year debentures or 10-year debentures like there are in fact in many foreign countries, but the problem there is that they tend to be more expensive types of funding.

Senator HEINZ. Those are decisions the market makes.

Mr. GREENSPAN. That is right.

Senator HEINZ. How can we in government influence that?

Mr. GREENSPAN. That is precisely the point. To the extent that we create incentives, and we have a test for thrifts in the QTL, the qualified thrift lender test, in which we make a judgment as to what proportion of mortgage type assets and liquidity should be in a thrift, there is no reason why perhaps—and I underscore, it is only hypothetical—why a differing view of how we end the remaining interest rate maturity mismatch cannot be put forward because I think that is an issue which still remains unresolved. it was an issue which I believe was addressed very strenuously earlier in this decade.

I think we all felt we had vehicles which would lengthen the maturities on the liability side, and it turned out, as you point out, Senator, that the market was not basically receptive to that, and it may turn out at the end of the day that we can't figure a way which would be helpful to do that, but it is useful to look.

Senator HEINZ. Mr. Chairman, thank you very much. If there is a second round, I hope to return for that.

The CHAIRMAN. Yes, indeed, I expect there will be.

Let me acknowledge Senators Kerry and Dixon and Roth have all joined us. I don't know if any of you have an opening statement you would like to put into the record at this point.

Senator DIXON. Please, Mr. Chairman, I would like that.

The CHAIRMAN. Without objection, for Senator Dixon.

[The complete prepared statement of Senator Dixon follows:]

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee continues its hearings on how to appropriately respond to the crisis facing our Nation's thrift industry and its federally sponsored deposit insurance fund. Today, we have before us the distinguished Chairman of the Federal Reserve Board, Alan Greenspan. I know the committee will benefit greatly from the great expertise Chairman Greenspan brings to this issue.

Chairman Greenspan, I think there is one issue in particular where you can be particularly helpful to this committee—how to analyze the impacts on the thrift industry of the changes in regulation and the financial contribution to the resolution of the FSLIC problem.

As you know, the administration plan calls for the thrift industry to pay the principal amount—by purchasing zero-coupon bonds—of the $50 billion needed to resolve the current savings and loan insolvencies. It also requires the thrifts to increase their capital to 6 percent in a relatively brief period of time, and it phases out quite rapidly their ability to make use of good will on their balance sheets. Finally, it requires the savings and loan industry to finance the creation of the new FSLIC account at the Federal Deposit Insurance of Corporation.

I want the thrift industry to make the maximum contribution it can to resolve this crisis. Before we ask the taxpayer to make any contribution, we have to get every penny we can from the industry. I also think it is absolutely imperative to get the industry to increase its capital—and to make sure that capital is real, not phony—just as fast as we can.

I am greatly concerned, however, that if we try to do all of these things too fast, we will not meet our No. 1 objective: To ensure that we resolve this crisis once and for all, ensuring that it will never happen again. We will not have succeeded if, as a result to the legislation we enact, we leave the thrift industry financially crippled, unable to make the profits it needs to be successful in the long run. I hope you will tell us, therefore, whether you believe the industry can meet all the objectives the administration set out as rapidly as has been proposed, and if not, what kind of timetable and what kind of other adjustment might be needed.

Thank you, Mr Chairman.

The CHAIRMAN. Senator Roth.

Senator ROTH. I have no statement, Mr. Chairman. I do want to congratulate you for the expeditious manner in which you have been holding these hearings, the bipartisan approach. I think your promptness and the fact that the administration has acted early bodes well for the future, and I thank you for that.

The CHAIRMAN. Thank you.

Senator Bryan.

Senator BRYAN. Chairman Greenspan, I can understand, as I think all of us can, the difficulty of looking into a crystal ball and seeing where the economy is going to be 3 years, 4 years, 5 years, particularly in light of the rather turbulent economic history of the past decade, but I think that you would agree that for the Congress the plan that has been proposed by the administration ought to be based upon a reasonable predicate.

My question is, is this a reasonable predicate in terms of some of the projections that are incorporated in this plan?

As I understand the thrift rescue package, the administration assumes that interest rates on FSLIC notes will fall from 9.5 percent in fiscal year 1989 to 4 percent in fiscal year 1994 and that in addition to that there will be a growth in deposits in the thrift industry itself.

My question is, is that a reasonable economic assumption?

Mr. GREENSPAN. Unfortunately, Senator, I am at a disadvantage owing to my job in being able to comment on interest rate forecasts. [Laughter.]

I am caught in this respect and not able to respond to that.

My recollection is that they are assuming a 7-percent increase in S&L liabilities. That is not an unreasonable number. You can run simulations with any different sets of numbers and interest rate assumptions, and you will come out with different numbers.

But I think what comes across is that, within a broad realistic range of assumptions, the rough cut of the numbers is approximately the same. In other words, we are not dealing with something which can be funded with $5 billion, and it is very clear that to double what the administration's program is is hugely out of line.

There is a range, and what I am saying—and the reason I use the image of projecting a rocket into orbit and then getting a midcourse correction—is that what the Congress has to do in this legislation is get us into orbit and worry exactly how we fine-tune it later because there is no way to get us to that fine-tuned orbit from the ground, so to speak.

Senator BRYAN. Let me approach the question a bit differently.

If you were drafting the package yourself, aside from your inability to comment on interest rate projections down the road because of your position, what provisions in addition to those which may be included in this package or what provisions that are included in this package would you delete?

Mr. GREENSPAN. You mean as far as the legislation is concerned?

Senator BRYAN. Yes, as far as the legislation. If you were going back to the drawing board is my question.

Mr. GREENSPAN. It is an interesting problem. I was part of the process. In other words, I argued a lot of points, I must say.

Senator BRYAN. Without being rude, why don't you tell us the arguments that you lost? [Laughter.]

Mr. GREENSPAN. That is precisely what I don't think is a fair approach.

In other words, we all entered this process, recognizing that there was a major national problem. We had differences—I am talking now about the Treasury, the FDIC, the Office of the Comptroller of the Currency, and the Federal Reserve. We all combined and tried to find a solution, and in the process, we all had to forgo certain things, but we all found in the end that the total package was a superior package to any of the others that we could conceive of.

My view is that when you are in a negotiation and you get most of what you think is important—in fact, virtually all of the things which are really important—I don't think that it is appropriate under those conditions to be other than fully supportive of the total package, which I am, because I think it is a good package. I know of nothing in it that I think is detrimental to the American financial system nor to the economy as a whole.

Senator BRYAN. Mr. Chairman, I wasn't trying to get you to disavow the legislative proposal, but it might help the Congress if you felt inclined to do so to share, based upon the experience that you have as a result of the position which you enjoy, any provisions that you thought from the perspective of the Board that might be included in this legislation—we are all in a very bipartisan fashion trying to put together the very best piece of legislation we can, and I think we all recognize we need to act quickly.

Mr. GREENSPAN. It is a hard question to answer. You know what I mean?

Put yourself in my place. My judgment is, you know, you make a deal and it is a deal.

Senator BRYAN. All right, I understand where you are coming from. Let me refocus the line of questioning, then.

You have raised concerns about the liquidity of the thrift industry in light of the adverse publicity, as you recall, of the last couple of months. We have seen about a $15 billion withdrawal of deposits over the last couple of months.

I guess my question would be, what role do you see the Federal Reserve Board playing in terms of ameliorating that crisis?

Mr. GREENSPAN. In the short term problems?

Senator BRYAN. Yes.

Mr. GREENSPAN. We have always had various different types of contingency plans for any adverse circumstances that would emerge on the grounds that the crucial position of the Federal Reserve is to be the lender of last resort, and we take that very seriously.

Our view is that pending the enactment of this legislation and the construction of the RTC, should there be any difficulties, we in conjunction with the Federal Home Loan Bank System stand ready to make certain that the liquidity needs of the thrift institutions are met.

If I may take a minute, Mr. Chairman, I would like, if I may, to read the statement that Chairman Wall and I have agreed to with respect to precisely the issue which Senator Bryan has raised, and I would like to put it into the record. This has not been stated before.

The CHAIRMAN. Very good. This is the statement that has just been completed and that you are going to make public now?

STATEMENT BY ALAN GREENSPAN AND M. DANNY WALL

Mr. GREENSPAN. This is a statement that both Chairman Wall and myself are making with respect to this issue.

Arrangements have been established for the provision of liquidity support to savings and loan associations by the Federal Reserve Banks and the Federal Home Loan Banks.

The Federal Home Loan Banks, which are the first line of liquidity support for savings and loan associations, will continue to provide liquidity for thrifts that meet normal collateral standards. Under the new arrangement, Federal Home Loan Banks and Federal Reserve Banks will participate in a shared lending program to meet the liquidity needs of savings and loan associations that do not have access to normal sources of liquidity, including not only Home Loan Bank advances but also brokered funds and funding derived from repurchase agreements.

Since insured deposits at savings and loan associations are guaranteed by the Federal Savings and Loan Insurance Corporation, and the Congress and the President have pledged the full faith and credit of the United States behind the FSLIC's deposit guarantee, it is not anticipated that there will be significant withdrawals from savings institutions.

Loans made by the Federal Reserve Banks and Home Loan Banks under the shared lending program will be collateralized by assets held by the borrowing thrift and guaranteed by the FSLIC. Under the S&L reform and restructuring legislation proposed by the administration, the guarantees made by the FSLIC under this shared lending arrangement would be assumed by the Resolution Trust Corporation.

The Treasury is also participating in this program by advancing funds under the statutory line of credit to the Federal Savings and Loan Insurance Corporation, and these funds will, in turn, be made available to thrifts as part of the shared lending.

End of statement.

The CHAIRMAN. Senator Bryan, you raised that question, and that is a very important statement that Chairman Greenspan has just delivered on behalf of himself and Mr. Wall.

Did you have a follow-up question or comment that you want to make before we move on?

Senator BRYAN. I will yield my time and come back on the second round, if I may, Mr. Chairman.

The CHAIRMAN. Let me acknowledge, also, that Senator Dodd and Senator Kassebaum are now here and have come from other committees.

Senator Dodd, did you have a comment?

Senator DODD. No, Mr. Chairman, just to welcome the Chairman again.

The CHAIRMAN. Senator Kassebaum.

Senator KASSEBAUM. No statements.

The CHAIRMAN. Senator Mack.

Senator MACK. Mr. Chairman, this may sound like a continuation of Mr. Bryan's earlier question. It is not really intended to. It is focusing in on the idea of flexibility you have raised and the need for an understanding that midcourse corrections in fact may be needed.

I am just wondering if there is something we ought to be putting into the legislation that provides for that flexibility, or is there a sufficient amount of flexibility in the plan that we are looking at already?

Mr. GREENSPAN. I think there is sufficient flexibility. I think everyone has recognized that, and I think the size of the authorizations and the structure that is being set up may very well not require midcourse corrections.

But what I am saying is it should not be structured, or thought of as one that prohibits a correction, because we are going to learn a good deal more about what the size of the problem is and the means of resolving of it, and it is conceivable that, as currently contemplated by the administration, we may be overfunding. We may be underfunding. I don't think we know, and I don't think we need to know. In fact, I know we don't need to know at this stage except for academic reasons.

Senator MACK. I think a number of the questions that have been raised this morning are really kind of going to the heart of the question, that once this is completed—when I say "completed" really I am talking about 1991-92 for the capital requirements of the remaining institutions—is what impact will this have on the savings and loans themselves in the sense of the availability of funds for mortgage lending, the number of institutions?

I mean, there is a feeling that at some point a number of the savings and loans are going to get out of FSLIC and move into FDIC.

I guess what I am working toward is, if you can, to give me a feel for what you and the Federal Reserve see out there in, let's say, the early 1990's with respect to the structure, the number of institutions.

Will there be a sufficient number of institutions to provide for the origination of those mortgages, or are we really kind of beginning the step moving toward, you might say, a single commercial banking process as opposed to the dual system we now see of savings and loans and banks?

Mr. GREENSPAN. I think the dual system clearly will be there for the indefinite future, and I would suspect that as part of the Treasury study that is contemplated in its legislation, that that type of evaluation, that type of projection, that type of analysis will very likely be made.

We haven't done it in the detail that you are discussing, and I couldn't answer your questions directly, but I do think that what we will see is that clearly the mortgage function which is so crucial to homeownership in this country and has as such, an extraordinarily important value has got to take the front seat, be first premise, so to speak, and work back from there.

How basically it will evolve I think will in part depend on the continuation, of securitization, but remember that there is something unique about mortgages; namely, that they are essentially a local product and require a credit judgment by a person knowledgeable about a local area who understands the local market. No matter how national the mortgage market is, originations will never be other than local.

That is a very important function of the system. Now, whether or not that will be as heavily involved with savings and loans as it still is, and I suspect it probably will continue to be by the nature of the institution, or whether the share will increase, I frankly don't know.

Senator MACK. Let me just raise one other area—you touched on it in your testimony on page 12—having to do with the review of the insurance system itself.

I gather really that there are a lot of different issues that have come up for discussion, but there is a feeling we really ought to address those at some later date and not kind of drag this piece of legislation down with additional debates.

But since you raised the issue about deposit insurance, I gather from what you are saying that we really ought to take a look as to whether there should be some restructuring of deposit insurance, what role it plays in the overall market and the decisions that people make about placement of your deposits.

Would you give me some kind of feel what the parameters you think might be for that discussion?

Mr. GREENSPAN. I think what we have to do is recognize that we have now had the system in place for several generations, and a thorough review of the system and its benefits and shortcomings is probably about due, in any event. I think that even were the FSLIC crisis not to have emerged, I would suspect that we would be looking at this.

There has been a great deal of academic focus on the question of deposit insurance, the so-called moral hazard problems and risk-based capital and insurance.

Remember, the concept of insurance is not unrelated to the concept of capital because obviously if you have 50 percent of your assets backed by capital they are not going to need any deposit insurance, and the lower the capital, the greater the importance of deposit insurance. I would think that one major issue here is the relationship between capital requirements and insurance fees and insurance requirements and what ways do we have of mitigating the problems of moral hazard, which is indigenous to the deposit insurance system.

Senator MACK. Thank you.

The CHAIRMAN. Thank you very much, Senator Mack.

We have had two other members arrive, Senator Gramm and Senator Bond.

I am wondering if either of you want to make just a brief comment before we go to the next person in questioning order.

Senator Gramm, do you have such a desire?

Senator GRAMM. Mr. Chairman, let me be brief.

I appreciate having our distinguished colleague from the Federal Reserve Board back. It is good that you don't have a regular job so that you can come over here every day. [Laughter.]

It always enlightens us. I think your point about the bill is correct; that is, that the important thing is that we act quickly and if things do have to be changed later—and knowing how things change, I suspect they will—that we can come back and fix it.

So I appreciate your input. I don't know anybody in this city who is listened to more closely by this committee than you, Chairman Greenspan, and I am delighted that you are here.

The CHAIRMAN. Senator Bond.

Senator BOND. I can't expand on that further. I will wait till the questions.

Thank you.

The CHAIRMAN. Let me just say, in yielding across now to Senator Graham from Florida, that the committee might want to take a look at the study that has been talked about here about the future of the structure of the financial services industry. It is on page 328 and 329 of the document that we were given yesterday.

I have just read it again. It is a very interesting description, and it does raise the question, is this a cat's paw toward maybe doing away with the savings and loan industry, at least in the minds of some. They can judge that for themselves.

But in any event, that is where we can look at to see exactly how it is phrased.

With that, Senator Graham of Florida.

Senator GRAHAM. Thank you, Mr. Chairman. I understand we are going to have a second round of questioning.

The CHAIRMAN. Yes.

Senator GRAHAM. With that understanding, I would like to hold my questions relative to the financing program and focus on structural questions in this first round.

There is certainly ample blame to be spread around as to why we are having this circumstance today, but I think that part of that has to be focused on those who in the very recent past have advised this committee and others in Congress that we didn't have a problem and therefore discouraged any sense of urgency to get on with the task.

I would like, Mr. Chairman, if I could bring to the committee's attention a statement which was made on May 26, 1988 by the Chairman of the Home Loan Bank Board, where on page 8 of his statement he makes the observation:

> Together with deposit premiums and other resources available to us; that is, FSLIC, these funds have enabled the FSLIC to begin resolving those cases on which it had previously been unable to act.

Then, moving forward to page 13, he continues:

> The Board projects that FSLIC possesses adequate resources in the near term to deal (sic) effectively with problem institutions in the thrift industry. This projection depends upon other segments of the thrift industry remaining stable and assumes no significant increase in interest rates or dramatic downturn in other sectors of the economy.

We had testimony a few weeks later by the Assistant Secretary of the Treasury which affirmatively discouraged any congressional action. The exact quote which was in August of last year was:

> I urge this committee in the strongest possible terms to resist mounting pressure for an unnecessary budget busting bailout of FSLIC.

So that was the environment in which this committee was operating as recently as last spring, summer, and fall.

In the context of that, I am concerned about the issue of the independence of the Home Loan Bank Board from pressure.

In your statement you comment on page 6 that the new regulator, the Chairman of the Federal Home Loan Bank System, who would be under the Secretary of the Treasury in the same relationship as the Comptroller of the Currency, should be more independent from the industry. We don't talk about independence from the administration.

Would you comment as to why you believe that having this agency under the Treasury is a desirable structural relationship?

It seems to me that from the examples and the quotations I have made what we need is more independence and the ability to be candid and honest about what the situation is, not creating a circumstance that would be more likely to be subject to political manipulation and avoidance of reality.

FHLBB UNDER SECRETARY OF THE TREASURY

Mr. GREENSPAN. This is a difficult question, Senator, and I have come out on both sides on this issue over the years. In fact, I was a member of the commission in 1971 that was strongly supportive of independent supervisory and regulatory units in the banking and thrift area.

Having come into government and watched the way it functions in the 1970's and since, it depends very much on the personalities involved, and I think, for example, that with some exceptions, the Office of the Comptroller of the Currency has functioned independently and is, I think, quite a well structured and effective organization.

The FDIC and the Federeal Reserve clearly have also as best I can judge.

I think we are all potentially susceptible to various types of pressures, and my impression is that it is probably more an issue of the individuals involved rather than our institutional position.

I think that the Comptroller's Office has functioned reasonably well since 1863 and we have functioned well since 1913.

I think I find no real preference, nor do I really myself feel strongly one way or another on this subject.

Senator GRAHAM. I am concerned that the types of representations which I think created an environment of "Don't worry, be happy" in 1988 are going to be more likely to occur if the independence of the Chairman of the Home Loan Bank Board is even further diluted by placing him directly under a person or an institution which was last year saying we strongly urge no action on this issue.

Mr. GREENSPAN. I understand that position. As I say, I can argue weakly on both sides.

Senator GRAHAM. We are talking about, I think, a very fundamental issue——

Mr. GREENSPAN. I don't dispute that.

Senator GRAHAM [continuing.] Of the long term relationships between financial regulation and political accountability.

Mr. GREENSPAN. The thing which concerns me is if we make it a fundamental principle then I think we are probably required to restructure the Comptroller of the Currency's Office, and I would frankly hate to see that because I think it has over the years been very effective.

Merely to structure it on a comparable basis with other regulatory institutions strikes me as really quite unnecessary.

The CHAIRMAN. I would just make the observation before yielding to Senator Roth. We have to live with our structures over time. If we have to depend to any great degree on the personalities involved—your phrase, not mine—then given these kinds of enormous dollar risks I start to get queasy. We are a government of laws and structures rather than of individuals because you can get very wide variations, and I think I would like to have a structure that is well enough designed and sound enough that it can withstand the variations in personalities.

Senator Roth.

Senator Roth. Thank you, Mr. Chairman.

I, too, would like to welcome my good friend, Alan Greenspan. I think we are indeed very fortunate to have a man of your caliber in the position he now holds.

I guess it can be said that FDIC and FSLIC insurance imposes on the taxpayer the largest on-fund liability that we have, something like $2.7 billion. This of course increases whenever a deposit is made.

I wonder, is this something that should concern us? Is there anything we should be seeking to do long term to downsize that potential liability?

Mr. Greenspan. Senator, I am not sure we can down-size it, but I think as part of the Secretary of the Treasury's recommended study that, with respect to its size, its vulnerability and, far more importantly, with respect to the issues that analysts have called moral hazards, we should take another shot at thinking it through. Moral hazard raises the additional question as to whether deposit insurance induces perverse incentives to the financial system, that is, while it may protect the depositor, it may create a misuse of resources. It is an issue which we have struggled with since the beginning of deposit insurance.

We have never successfully come to grips with it. What we have got to do is to find the means by which insurance is kept in place, and strengthen the valuable parts of this system. However, we also need to see whether, without in any way undercutting that support, we can improve it structurally.

Senator Roth. Last year the Senate was of course willing to expand the banking powers on the basis of the experience with savings and loans, or at least some who say the reason we are in the difficulty is that they were permitted to expand their powers and authority.

Do you see any kind of similar risk in expanding banking powers in the future?

EXPANDING BANKING POWERS IN THE FUTURE

Mr. Greenspan. No, I don't, Senator. I think that the causes of the problems of thrifts through the late 1970's and through the 1980's only marginally dealt with the powers expansion.

The crucial issue with respect to powers expansion is that we have had very poor, inadequate supervision and regulation, and I think that implicit in any powers expansion is an awareness of the fact that there are potential increased risks.

The reason you expand powers is that you make the judgment that the value to the financial system and to the economy is greater than the potential risks that are involved, not that the risks are zero.

I do think it is incumbent upon us to put sufficient safeguards in place, such as in S. 1886, to significantly reduce the risks which do occur as a consequence of expanding powers.

The problem with the thrifts was that we expanded powers but we did not appropriately endeavor to constrain the risks in the way we should have done.

Senator ROTH. Let me ask you a further question about the liberalization of banking powers.

Would it make any sense as a measure to partially help relieve the taxpayer that those liberal powers be used as some kind of sweetener? In other words, banks that bought up savings and loans would be the first to secure broader powers?

Mr. GREENSPAN. I feel uncomfortable with that sort of trade, Senator. I believe that powers generally should be granted because they are the right thing to do.

There are occasions, especially in certain regulatory areas, where we think it is desirable, for example, to match the acquisition of failed thrifts with other types of institutions because it helps certain local or specific structures, but I would not want to extend that into a broad principle which would be embodied in major legislation.

Senator ROTH. My time is up. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Wirth.

Senator WIRTH. Thank you very much, Mr. Chairman.

Again, Mr. Greenspan, welcome. You probably have a cot in the back here.

Let me first of all ask you about your potential role coming up as a member of the Oversight Board of the RTC. You have potentially some very complicated and problematic issues in my area of the country related to assets that are now held by the FSLIC.

I got information from FSLIC as a result of a request. Currently, they told us, the FSLIC holds about $7.5 billion in assets. This is at discounted values—about $7.5 billion. Of that amount, about half a billion dollars is in the State of Colorado, and just as a side bar to that, $450 million comes out of the Silverado collapse alone. We have $500 million of property assets or other assets that the FSLIC owns.

Obviously, in an economy as relatively small as that in the State of Colorado, if that $½ billion were to be thrown right on the market, that would cause all kinds of other ripple effect problems.

We talked about that a little bit earlier. I wondered if you might give us your views as a potential member of the Oversight Committee of this new group as to how you might consider working out these problems over a long period of time rather than, as I assume you would agree, dumping it on the market immediately, which would cause all kinds of other problems?

Mr. GREENSPAN. I agree with that, Senator. I think there are two issues one has to be concerned about.

One is that when you drop assets on the market for whatever price they will obtain, that will break almost any market, and that is clearly inappropriate, not only for local communities, but also inappropriate for getting the best values for the RTC.

On the other hand, what we also don't want to do is to have an overhang on the market where everyone is saying; "I don't know when they are going to drop the other shoe," or something like that. As a consequence of that, I think what you need to do is to have a series of procedures which recognize that the purpose of RTC is to maximize the values of those assets, maximize those prices, and the very process by which you do that also limits the negative effects on the local communities in which those assets are held.

Speaking generally of real estate assets, which are obviously immovable, one of the things I assume that the RTC will do is to try to find a means by which they don't drop the whole bundle immediately for whatever price will prevail but find a means to gradually feed real estate assets into markets so as not to upset the price structure and harm the local economies.

Senator WIRTH. What kind of safeguards should be built into the system, either through directives from the Board, you and the Attorney and the Secretary, or regulation or law? What kind of safeguards should be there to prohibit some kind of a knee-jerk, perhaps, bureaucratic reaction?

It is now in the law, I think, that there is a premium in putting these on the market right away. How do we assure that that doesn't happen and there is the sort of long term workout that you have been suggesting?

Mr. GREENSPAN. I would be careful about legislating that.

Senator WIRTH. I would be, too.

What safeguards do we have? That is the question. And should there be such?

Mr. GREENSPAN. Sure. What I think ought to be done is to have a preamble in the legislation which stipulates the general guidelines that the Oversight Board should follow. I can't conceive that we would have to tell these three individuals involved, whoever happens to hold those offices, because they are all Presidential appointees and basically those who appear in extended hearings before the Senate and the Congress generally.

I would hope that these individuals would be sufficiently sensitive that we won't have to tell them.

Senator WIRTH. I think that is right. I don't have any question about those three individuals.

What I do have a question about is a large bureaucracy down below governed by various pieces of legislation, some of which were passed some years ago. I am thinking in particular about the FADA group that has, I think, the legislative mandate to unload this property as expeditiously as possible. It seems to me that we want to make sure this doesn't happen.

Can we get, say, a draft from your people as to what that ought to be?

Mr. GREENSPAN. I think it is a legitimate request for us—and I won't speak for my colleague, the Secretary of the Treasury—to perhaps sit down and think through how the Oversight Board would control RTC overall.

Senator WIRTH. Texas might have a similar kind of problem. Oklahoma, Louisiana might have a similar kind of a problem immediately—and that it might be a good idea to have at least on paper what you think are the principles that should govern this.

That in turn could be sent out to the regulatory agencies who at this point have got to be looking for guidance.

On something as crucial as this, with so much money involved, we ought to be sending some guidance at this point.

Mr. GREENSPAN. FADA under this proposal, as I am sure you are aware, is eliminated.

Senator WIRTH. But there is going to be something else out there—if FADA disappeared. There is going to be something else out there. Whether they are called FADA, a disposal agency or whatever, there is going to be somebody else out there.

Mr. GREENSPAN. I like the name. Resolution Trust strikes me as better.

Senator WIRTH. I am a Resolution Truster, trust me, but I am not sure we ought to trust these guys to exercise the kind of long term discretion that has to be done.

Mr. GREENSPAN. I think we will try to present to this committee a set of rules which would describe how we would view the operations of RTC under the conditions which you stipulate.

Senator WIRTH. Thank you, Mr. Chairman.

Mr. Chairman, I think there is going to be a very important issue before the legislation gets passed. We are going to have to have some kind of interim direction, and we would like to work with you in doing that.

Thank you, Mr. Chairman. We are delighted you are here today.

The CHAIRMAN. I think that is a very important issue, Senator Wirth. We will make your request a committee request because I know Senator Gramm has raised that issue with me, as have others, in terms of the manner in which assets are disposed of so we don't really in a sense add to our problems.

Senator Kassebaum.

Senator KASSEBAUM. Chairman Greenspan, I join with everyone else who comments on how much your observations are respected and valued. I think your testimony here this morning is again a good example, one focusing on acting expeditiously, and the focus and attention you give to the study of the Nation's deposit insurance system.

In that paragraph, the first paragraph, in which you address that, you comment on the unintended expansion of insurance coverage through such techniques as brokering deposits.

What suggestions do you have on what we can do about brokered deposits?

BROKERED DEPOSITS

Mr. GREENSPAN. I am not a great fan of brokered deposits, but I must say to you I find it difficult to figure out a way to alter that at this stage. It is extraordinarily difficult to try to administer restrictions on brokered deposits.

Really, the technical problems involved in trying to identify who holds funds and where is very difficult. Also, of course, you have got the capability of individual thrifts themselves to go out into the country and get large blocks, then distribute them among a series of different institutions, in a holding company or something of that sort.

There are a lot of problems. I do think it should be evaluated. I do think it has been part of our problem.

It obviously has some major advantages. It does help the liquidity of the system, and it is not all negative by any means. In fact, in the early stages I thought it was really a major advance, and it may well be that if you could find a way to just prevent the types of avalanche of brokered deposits which created difficulties at the tail-end of the FSLIC problem, it may be that they will serve an unquestioned positive purpose.

Senator KASSEBAUM. I appreciate the difficulties, and perhaps, as you say, what one does about it. I am not sure whether with the technology we have today we can do this, but is one way just simply not to insure those types of deposits so there is some benefit to be gained or undertaken, knowing that there would not be insurance?

Mr. GREENSPAN. If we all had a solution to that problem and we all thought it was a reasonable recommendation, I think we would have made it in this legislation.

One of the reasons it is in the study, of course, is we recognize the complexity of the issue, and while we all have problems with brokered deposits, we are all aware of the fact that they do serve a useful purpose, and that the whole question of the way the system works, suggests it should not be just shut down without evaluation. I would hope that the study would review this from all aspects and address in a most sophisticated way the questions that you raise.

Senator KASSEBAUM. In 1984, as I am sure you know, FDIC and the Federal Home Loan Bank did recommend that something be done about brokered deposits. That fell through for other reasons, and I am not aware of some of the arguments that were made at that time as far as the difficulty due to technology.

All of that may have changed, and I need to go back and review some of the reasons in 1984 why the courts actually intervened.

I would like to just go on.

In your talking about the issuance of the notes and carrying the full faith and credit of the United States, so in a sense they are like Government bonds, is that correct?

Mr. GREENSPAN. I am sorry, Senator. Which notes are we referring to?

Senator KASSEBAUM. I am sorry, the FSLIC notes that were issued in December.

Mr. GREENSPAN. Yes.

Senator KASSEBAUM. They carry the full faith and credit of the United States?

Mr. GREENSPAN. As I understand it.

The CHAIRMAN. I am sorry, did I hear that?

Mr. GREENSPAN. As I said, they would under this legislation certainly, but there has been a good deal of discussion in the press as to whether or not——

Senator KASSEBAUM. I thought in answer to Senator Bryan you said the issuance of which carried the full faith and credit.

Mr. GREENSPAN. The answer is yes.

Senator KASSEBAUM. My question really is, then, have you figured them—how do they figure in your calculation in monetary policies?

Mr. GREENSPAN. These particular notes?

Senator KASSEBAUM. Does that make any difference in your calculations?

Mr. GREENSPAN. No, I don't think so, Senator.

I think, as I indicated here, I believe on Tuesday, the one thing about this whole FSLIC crisis is the extent to which the financial community has absorbed it and, in a sense, discounted virtually all reasonable actions to resolve it.

As far as the financial markets are concerned, the deposits of RAP-insolvent thrifts are backed by the full faith and credit of the United States up to the $100,000 insurance level. Once that instrument, that is, that deposit, is insured, if you substitute for the deposit another note which is also insured, there is no interest rate effect.

In that sense the markets have basically already subsumed virtually all of what we have been talking about this morning and have adjusted. All we are talking about is shifting instruments within the system and substituting, say, possibly FSLIC notes for thrift deposits, as an example.

Senator KASSEBAUM. Thank you.

The CHAIRMAN. Thank you, Senator Kassebaum. I just want to make an observation off your questions.

We are having tremendous participation by the members of the committee, and it is so important that be done, and I know it is difficult because everyone has other committee assignments to have to go back and forth between. We have had 17 Senators on this committee today here taking part in the activity. It is a measure of the seriousness of the problem and the strenuous effort of committee members and obviously the importance of our witness today.

Senator Dodd.

Senator DODD. Thank you, Mr. Chairman.

Again, welcome, Chairman Greenspan.

Let me, if I can, go back to two questions. I think you addressed some of these already, but I would like to revisit them if I could.

One is on the adequacy of the deposit insurance funds. The other is on the limits of capital standards and your comments on them.

We know in the plan that Treasury has chosen a level of 1.25 percent of deposits as the proper level. I would like to know whether or not you agree with that.

Mr. GREENSPAN. Yes, I do. In fact, that was my number. [Laughter.]

Senator DODD. I should have known that before.

The Treasury has also determined that in the long run the greater powers exercised by the S&L's warrant a three basis point difference in premiums.

Was that your idea, too?

Mr. GREENSPAN. No, I didn't get all the numbers.

Senator DODD. Do you agree with that number?

Mr. GREENSPAN. Yes, I do.

Senator DODD. How wide, in your view, can that differential get before the S&L's would be put at a competitive disadvantage?

Mr. GREENSPAN. Three basis points is really not a crucial issue. What would be, I think, is if we kept the 23 basis points continuing against the 15 basis points for commercial banks. I think that would create problems.

We are, as you know, bringing that down from 23 to 18, and I would say a three basis point spread is scarcely visible.

Senator DODD. On the capital standards question, again. Senator Garn—I believe you addressed the question of 2½ years as the timetable to get to the 6 percent level of capital. In response, Chairman Greenspan you mentioned, the 10 years on good will.

Some banks don't have any good will at all.

Do you still hold that general review in response to the question by Senator Garn, even with regard to those institutions that don't have good will?

Mr. GREENSPAN. You mean in the sense that 2 years is adequate?

Senator DODD. Yes.

CAPITAL STANDARDS

Mr. GREENSPAN. Remember that what we are talking about here is basically to take the capital standards of thrifts up to a higher level because it is clear that in the deposit insurance system 3 percent is really too low.

As I think I was saying in answer to Senator Mack, I keep mentioning the issue of the relationship between capital requirements on the one hand and insurance requirements on the other.

Senator DODD. Having enough capital but not enough insurance?

Mr. GREENSPAN. Yes. They are really offsetting. The basic problem here is that we have got to get increased capital. If the thrifts fail to get capital all the way up to 6 percent in 2 years, what happens under this proposed legislation is that asset growth is frozen, which means they have the possibility of accumulating capital and gradually bringing up their capital so that the denominator isn't rising sharply and making it increasingly more difficult.

I think we ought to constrict the growth of those institutions whose capital is inadequate and who are insured. I think that one of the things that we ran into trouble on is that we did not consider that important. I think we were all wrong, all of us.

Senator DODD. That expands on what you said in your statement, which is that if losses continue to accelerate due to further credit deterioration or interest rate exposure, the industry's need for capital could be substantial.

In the last couple of days you have indicated that we could be looking at some interest rate rise.

I am just curious as to whether or not you have calculated what a 1-percent interest rate increase would mean in terms of the need for additional capital.

Mr. GREENSPAN. Sure, we have, but let me further state. Remember that we are talking about restructuring these institutions over a long period of time. Monetary policy is day to day, and I wouldn't want to try to intermingle the two because I don't know what interest rates are going to be 2, 3, or 4 years from now.

Senator DODD. Well, what would a 1-percent increase mean in terms of capital?

Mr. GREENSPAN. You need to make a lot more assumptions than that. You need to know what the growth in deposits is going to be and a number of other considerations.

I don't recall our having that specific number. I might add, Senator—and this is certainly true—that as interest rates go up thrifts' earnings go down and their accumulation of capital as a consequence goes down. It is precisely that problem which I would like to see eventually corrected; namely, the mismatch of maturities which makes these institutions subject to interest rate fluctuations.

Senator DODD. That is the point, in a sense. The plan calls for that kind of increase at the very time we may be facing some interest rate increases.

Mr. GREENSPAN. I would say that in our evaluation it is not a crucial issue. I mean, it clearly adds to the numbers, but the big problem is the shortfall in capital, and relatively small changes in interest rates one way or the other I don't think materially alters the size of what the capital requirements are.

Senator DODD. It says a 1-percent increase in inflation increases losses by $6 or $7 billion in losses annually. Is that right?

Mr. GREENSPAN. It depends on the mix. I don't know. Our estimate is that a 1-percent increase in interest rates creates $3 to $4 billion in operating losses per annum.

The CHAIRMAN. Chairman Greenspan, let me ask you to provide something for us—I would like the Fed to prepare for us your calculation of the dollar cost of the plan over the 30-year period. If you want to split it into increments, that is fine, but I want to see the Fed's calculation of the total cost of the plan. I would like to see it two ways. I would like to see the actual dollar cost, then I would like to see the discounted version of that that you were referring to earlier.

Mr. GREENSPAN. Mr. Chairman, I do have a problem with that. Implicit in any such estimate is an interest rate forecast, and I frankly don't have that.

The CHAIRMAN. I am not asking you to invent one. Those assumptions are built into the administration's plan. So use their assumptions. I just want the math done by you.

Could we have that by Monday, do you think?

Mr. GREENSPAN. Yes.

[The following information was subsequently submitted for the record:]

Insert page 83 (2/23/89 hearing)

Chairman Greenspan subsequently submitted the following:

Question: Given the Treasury's projections of the revenues and expenses of the thrift industry's insurance fund, what would be the cost to the Treasury of its proposed funding plan?

Answer: The Treasury's funding plan has three objectives: (1) to provide sufficient funds to pay off FSLIC's existing obligations, which were incurred primarily as part of its 1988 resolutions; (2) to provide sufficient funds to resolve the remaining insolvent thrifts and other marginal institutions that become insolvent over the next three years; and (3) to capitalize a new insurance fund for the healthy segment of the industry. To carry out these objectives the plan would create three new entities: (1) the FSLIC Resolution Funding Corporation, which would assume the existing assets and obligations of FSLIC; (2) the Resolution Trust Corporation (RTC), which would be responsible for resolving currently insolvent thrifts and those that became insolvent in the three years following enactment of the proposal; and (3) the Savings Association Insurance Fund (SAIF), which would assume responsibility for resolving insolvent thrifts after RTC's responsibility terminates. In addition, the proposal would create a Resolution Funding Corporation (REFCORP), which would issue $50 billion in bonds and use the proceeds to capitalize the RTC.

The Treasury's proposal includes separate financial commitments by the Treasury to the FSLIC Resolution Funding Corporation, REFCORP, and SAIF. To meet FSLIC's existing obligations, the FSLIC Resolution Funding Corporation would be funded with the proceeds of sales of FSLIC's existing assets, the proceeds of utilization of the remaining FICO bond authority and, through year-end 1991, deposit insurance premiums paid by members of SAIF (net of amounts needed to service FICO bonds and specified amounts paid to REFCORP). To the extent these funds prove insufficient to meet the FSLIC Resolution Fund's obligations, the Treasury would be committed to make up any shortfalls. Column 2 of the attached table shows the Treasury's projections of its disbursements under the backup facility. By far the largest payments occur in FY 1998 and FY 1999, when large volumes of FSLIC notes issued during 1988 are scheduled to mature. As shown at the bottom of the column, the Treasury's payments to the FSLIC Resolution Funding Corporation are projected to accumulate to $37.7 billion. Using a 9 percent discount rate, the present discounted value of these payments would be $22.2 billion.

Treasury's commitment to REFCORP is to guarantee payment of interest on the $50 billion of bonds it would issue--$10 billion in FY 1989, $25 billion in FY 1990, and $15 billion in FY 1991. Portions of the interest on the debt would be paid from proceeds of the sale of RTC receivership assets (a total of $12 billion over the period from FY 1990 through FY 1995) and from the earnings of the FHLB System ($0.3 billion per annum, beginning in FY 1992). Nonetheless, as shown in column 3, the Treasury projects that it would pay most of the interest; over 32 years, its payments would total $93.2 billion, for a present discounted value of $26.4 billion.

The Treasury's commitment to SAIF specifies that it will advance whatever funds are necessary to ensure that SAIF's reserve increases on a schedule that would build it to $8.8 billion by the end of FY 1999. Based on Treasury's assumptions regarding premiums to be paid by SAIF members and post-RTC resolution costs, projections for cash payments to SAIF are shown in column 4. As shown at the bottom of the column, these payments would total $16.9 billion; their present value would be $10.6 billion.

Column 1 of the table adds Treasury's projected payments to the FSLIC Funding Corporation, REFCORP, and SAIF. As can be seen, they would total $147.8 billion. The present discounted value of these payments would be $59.2 billion.

It is worth noting that the impact of these payments on the unified budget deficit would be smaller than shown. In particular, because FSLIC notes were scored as cash outlays at the time they were issued, their repayment has no impact on the budget deficit. In addition, additions to the reserves of SAIF and of FDIC are scored as negative outlays in computing the budget deficit. Thus, although Treasury's payments to FSLIC Resolution Funding, RTC, and SAIF would total $76.4 billion from FY 1989 through FY 1999 (column 1 of the table), the cumulative impact of the Treasury's proposal on the deficit over this period would, as claimed, be only $39.9 billion (not shown in the table).

Cost of Treasury's Commitments
(Treasury's projections, billions of dollars)

Period	Total Payments (1)	Payments to FSLIC Resolution Funding (2)	Payments to REFCORP (3)	Payments to SAIF (4)
FY 1989	0.5	0.0	0.5	0.0
FY 1990	3.0	1.6	1.4	0.0
FY 1991	7.7	4.1	1.6	2.0
FY 1992	6.6	4.1	0.9	1.6
FY 1993	7.6	3.8	0.8	3.0
FY 1994	4.5	1.9	1.1	1.5
FY 1995	5.7	1.8	2.3	2.4
FY 1996	7.1	1.4	3.1	2.2
FY 1997	6.1	0.7	3.2	1.9
FY 1998	13.5	8.3	3.4	1.7
FY 1999	14.1	10.0	3.5	0.6
FY 2000	3.5	0.0	3.5	0.0
FY 2001	3.5	0.0	3.5	0.0
FY 2002	3.5	0.0	3.5	0.0
FY 2003	3.5	0.0	3.5	0.0
FY 2004	3.5	0.0	3.5	0.0
FY 2005	3.5	0.0	3.5	0.0
FY 2006	3.5	0.0	3.5	0.0
FY 2007	3.5	0.0	3.5	0.0
FY 2008	3.5	0.0	3.5	0.0
FY 2009	3.5	0.0	3.5	0.0
FY 2010	3.5	0.0	3.5	0.0
FY 2011	3.5	0.0	3.5	0.0
FY 2012	3.5	0.0	3.5	0.0
FY 2013	3.5	0.0	3.5	0.0
FY 2014	3.5	0.0	3.5	0.0
FY 2015	3.5	0.0	3.5	0.0
FY 2016	3.5	0.0	3.5	0.0
FY 2017	3.5	0.0	3.5	0.0
FY 2018	3.5	0.0	3.5	0.0
FY 2019	3.1	0.0	3.1	0.0
FY 2020	1.6	0.0	1.6	0.0
FY 2021	0.2	0.0	0.2	0.0
Cumulative Payments	147.8	37.7	93.2	16.9
Present Value of Payments[1]	59.2	22.2	26.4	10.6

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[1] All future payments are discounted at a 9 percent annual rate, about equal to recent yields on 30-year Treasury bonds.

Note: Cumulative payments may differ from OMB estimates because of rounding.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

Chairman Greenspan, I want to ask you about a couple of elements of the plan. I have been trying to think about this whole issue as to whether the Federal Home Loan Bank Board ought to come under the Treasury or whether it ought to remain independent.

My initial approach is that it depends on what kind of powers it is going to have, that that is going to be a lot more important than where it is housed in some organization chart.

But the more I thought about it, one point has popped up in my mind that is relevant to the debate. While the Comptroller of the Currency is under the Treasury, the Comptroller's Office really comes from the National Banking Act, which was a way of funding the war—the Yankee aggression war. [Laughter.]

In essence, the Comptroller of the Currency charters national banks and audits them, but it does not provide their liquidity nor does it set their reserve requirements. Now, national banks create money, and while the Treasury is not in the money creating business now and has not been in that business since the Civil War—except, I guess, for the final vestige of minting coins, and then there were $1 bills, but now you have taken over that business.

How much significance would you attribute to the fact that one might make the following argument. Savings and loans are banks since by any kind of classic textbook definition of banks that you and I learned out of and taught out of, savings and loans create money by issuing demand deposits, NOW accounts. That money creating capacity makes them a unique institution as compared to other institutions, except obviously for banks. It puts them into that unique category.

What would you think of the argument that because they do create money, symmetry with the current system would argue that the Federal Home Loan Bank Board should be independent, since it will have many of the same powers, or does have relative to the savings and loans, that you have with regard to the banks, and that to put them under the Treasury in essence gives the Treasury control of an institution that creates money?

TREASURY WOULD HAVE CONTROL OVER INSTITUTIONS THAT MAKE MONEY

Mr. GREENSPAN. I don't know, Senator. It is the first time I have heard this. I want to give you a thoughtful response, but I am not sure I can give you one now.

I have been more inclined, perhaps in the more narrow sense, to visualize the question as mainly one of the degree of independence of supervision and regulation as well as chartering from political influences. I think we have identified several.

One that has been of concern to some is that the Federal Home Loan Bank System has had its supervisory and regulatory functions, its chartering and its funding all in the same bailiwick in a manner which was considered to be susceptible to being influenced politically and which has led to the current proposal to separate out the system from its existing structure.

Whether or not you can then argue that the political influence of the Secretary of the Treasury then creates the other side of the problem is a legitimate argument.

I am not sure that I can integrate the question of the nature of the money creation capabilities. I would like, frankly, to give that some thought.

Senator **Gramm**. Let me give you one more variant of it.

I personally agree with breaking out the Federal Home Loan Bank Board and separating out FSLIC and bringing that under the FDIC, but then the question is, What do you do with the Federal Home Loan Bank Board?

And until I started thinking about it, my inclination was that it didn't matter. On the other hand, this Federal Home Loan Bank Board provides liquidity for an institution that creates money.

Mr. **Greenspan**. It is the banks that do that, not the Board. If you want——

Senator **Gramm**. But the institution does it.

Mr. **Greenspan**. OK.

Senator **Gramm**. The question is—given our historic evolution toward removing money creation power from the political process, which has been an evolution that has served the public well, in my opinion, the question is at the end of that evolution, at least at this point in looking at it, whether we want to go back now in this bailout package and give the Treasury control of institutions that create money.

My guess is that when you look at that—and I would like you to think about and give us your recommendation—that probably it induces one to oppose giving the Treasury control of the Federal Home Loan Bank Board.

I would also, if I may, just inject real quickly, Mr. Chairman, I would like to get your thoughts on this 6 percent capital requirement in 2 years.

As I look at my State, that would mean about $6.5 billion of total capital. The solvent institutions now have about $1.7 billion. If you just forget about all the bad assets out there that have not yet washed their way through the system, assume the Government is going to take all those—and, obviously, it is not from the better institutions—you are talking about coming up with $4.8 billion of new equity capital, either building it up in retained earnings at the same time you are paying more fees or attracting it from outside, even if there are no additional assets written off, and we know that there will be some.

I would like to have your view as to whether that 2-year target is really feasible. Is it desirable? Would it be wonderful? Yes. But could it really be done?

Mr. **Greenspan**. I don't think anyone has ever expected that it would be done completely in 2 years. What I think, however, has been the thrust of the proposed legislation is that those that don't shouldn't be growing until they are able to get there.

So what I think is involved here is not that if you don't make it you are through; it is basically that the risks to the insurance system are such that we should be very cautious about allowing these institutions to expose the insurance system until they have capital.

I think a large number, maybe the vast majority, will raise the capital in 2 years, but it is not conceivable to me that all will, and the question you then have got is if they don't do you want them overhanging the insurance system until their capital is built up.

And I think the implication, obviously, of the proposed legislation is no.

The CHAIRMAN. Thank you. I am next in the order. Senator Graham has to go to another situation shortly. So let me yield my slot in the order here to him at this point.

Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Chairman, you discussed earlier the process by which the gross cost of dealing with this problem was arrived at. There is then a secondary question, and that is how that gross number will be allocated as between various industry sources and the general taxpayers. That allocation is in significant part dependent upon some assumptions of the resources that will be available to the industry.

One of those is an assumption that there will be a deposit growth within the industry of 7 percent plus, compounded over the next 10 years.

There also are assumptions on interest rates.

Have you reviewed those assumptions, and do you believe that they are a realistic premise upon which to base the projection of the industry's share of this?

Mr. GREENSPAN. Senator, we have looked at the numbers, and as I indicated in my earlier remarks, we are generally in support of the orders of magnitude that they show. Obviously, our numbers will differ as will the Treasury's every time they change any of the individual assumptions, but I think the broad thrust of the Treasury's numbers is, I think, quite reasonable.

DEPOSIT GROWTH PROJECTIONS

Senator GRAHAM. I am particularly concerned about the reasonableness of the deposit growth projections, given a couple of factors.

One, what has been happening over the past period were deposits have been leaving the system.

Second, with the increase in capital and the change in the regulatory standards for evaluating the capital and a more than doubling of the deposit base, as this plan is premised upon, you are not talking about the levels of capital that have been the subject, but two to four times that amount to match the expanded size the industry is projected to have.

Mr. GREENSPAN. Senator, remember that we are not altogether independent, objective evaluators of what those numbers are because, remember, we have growth targets for M2 and M2 picks up a lot of what those assumptions are. So we have our own differences.

Senator GRAHAM. Are your M2 projections consistent with the deposit growth projections upon which that plan was predicated?

Mr. GREENSPAN. They are taking those numbers out farther than we have, so I frankly would have to look to see about the composition of other elements in M2 and M3.

Senator GRAHAM. I wonder if you could look at the assumptions upon which the industry side of this plan is to be financed for their consistency with those things for which you have specific responsibilities, such as projecting money supply growth, and your general expertise as an economist.

Mr. GREENSPAN. I don't think that we are going to find that there are going to be significant differences. We are not talking about either the 12 percent or 2-percent growth but we will be addressing that question soon.

[The following information was subsequently submitted for the record:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

March 23, 1989

The Honorable Bob Graham
United States Senate
Washington, D.C. 20510

Dear Senator:

During the hearing on February 23 on the Administration's proposal to deal with the thrift situation, you asked about the consistency of its deposit growth assumptions with our targets for M2 and M3. The most appropriate comparison probably is to our range for M3, since this aggregate includes large time deposits, which would be part of the base for assessing deposit insurance premiums.

Expansion of M3 depends on a number of factors in addition to growth of deposits at banks and thrifts. However, 7 percent deposit growth, as assumed by the Administration, by itself would be consistent with growth of M3 in the upper portion of the FOMC range of 3-1/2 to 7-1/2 percent for 1989. Thrift deposits have been substantially weaker of late. But, when viewed in the context of the overall Administration forecast for the economy and the President's proposal to deal with thrift difficulties, growth of this magnitude over several years may be entirely plausible. The forecast, as you recall, envisions fairly marked declines in interest rates, in response to the reduction in federal deficits in the President's budget proposal as well as to lower inflation. Experience suggests that when market interest rates drop, retail deposits at banks and thrifts accelerate appreciably. This occurs because rates paid by depository institutions on many retail deposits tend to lag the market, and as market rates decline, deposits at these institutions become relatively more attractive to savers. Moreover, the President's program will restore confidence in thrift institutions, enabling them better to compete for funds, not only with banks, but also with market investments. Greater inflows of retail deposits may not show through entirely to larger increases in total deposits if thrifts allow them to substitute to an extent for large CDs. However, total deposit flows still should be boosted substantially.

To be sure, over the very long run, deposit growth probably would need to slow to a pace more commensurate with progress toward price stability. But, under the circumstances of the Administration forecast, fairly rapid deposit growth for a time would not be inconsistent with moving toward reduced price pressures.

I hope this information is useful. Please let me know if I can be of further assistance.

Sincerely,

Senator GRAHAM. A second question. The plan calls for issuing a substantial amount of new public debt over a relatively short period of time.

What effect do you anticipate this additional borrowing will have on general interest rates?

Mr. GREENSPAN. Senator, we gave that a lot of thought in the early stages of these discussions and concluded that the market has substantially discounted pretty much any fundings that are likely to be made.

The best way of describing that is that at the moment if we had a consolidated balance sheet for the Federal Government on an accrued basis in which we included those institutions which, for example, are RAAP-insolvent as in fact obligations of the U.S. Government because we guarantee the liability side, basically what we are doing is replacing one instrument for another. The market has already absorbed the fact that there is this increased liability to the Federal Government, adjusted interest rates, to whatever extent they have been adjusted, and what we are now going through is and shifting assets from one balance sheet to another. But we are not creating net new credit, and that is crucial to the outcome.

Senator GRAHAM. Your comment that there has already been some absorption of this phenomenon, are you suggesting that some of the interest rate increase over the recent past has been a function of the market anticipating the plan that we are now considering?

Mr. GREENSPAN. I don't think so, Senator, but it is conceivable.

Senator GRAHAM. It seems to be inconsistent if you say that the market has already absorbed, integrated some of the expectations of this, but then you say that none of the interest rate increase would be attributable to this, is inconsistent.

Mr. GREENSPAN. I am not sure when this adjustment took place. The markets tend to discount quite well in advance, and it could very well be that what may be more relevant is that the decline in interest rates that bottomed out a couple of years ago may have come down a bit further were this crisis not there.

But, frankly, I don't know of any way to realistically judge that. As best we can judge, considering the size and the magnitudes of the markets we are dealing with—we are dealing with trillions of dollars—and even though this is huge relative to taxpayer funds, relative to the total system, it is not so overwhelming as to create very substantial market effects.

The CHAIRMAN. Thank you.

Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

I am interested in your view on the sticker issue, Mr. Chairman.

What do you think would be a fair way to resolve the question of the rug on the floor and the sticker on the door? What should it say?

Mr. GREENSPAN. I am a nonexpert on this issue, and I would like to stay that way. [Laughter.]

I really can't answer. I don't have a really thoughtful answer.

I am acutely aware of the property rights that everyone attributes to those different stickers, and I don't want to put myself in an adjudicating position because I don't think I know what I am talking about.

Senator BOND. It is a sticky question. [Laughter.]

I was hoping we could get some guidance from you, but I will note your views on that.

In your statement you discussed getting thrifts to refocus on home mortgage lending. You have also noted that a real problem came about with the spike in interest rates when the thrifts which had lent long on fixed rate mortgages and borrowed short with deposits.

CONCERN ABOUT ANOTHER CRISIS IN THE FUTURE

Are you concerned, given the fact that many consumers seem to be shy of going for the adjustable rate mortgages, that getting the thrift industry back to the 60-percent plus levels of lending to home mortgages could subject them to another crisis if we had another spike in interest rates?

Mr. GREENSPAN. Senator, there has been a major shift toward adjustable rate mortgages, but until we have more experience with them we won't know fully the extent to which they adjust in the system.

This is one of the reasons why I raised earlier in the discussion with Senator Heinz the presumed necessity to look into such things as can we find ways to increase the maturity of the liability side of thrifts which would enable us to solve part of the mismatch problem from the liability side as distinct from the asset side.

Clearly, adjustable rate mortgages, the increased powers to make consumer loans and utilize other short term instruments have helped a good deal in changing the problem of mismatch, but until we get that issue substantially resolved I would be concerned about their ability to be viable and healthy in an unstable environment.

I am not saying that banks are not subject to this problem. They are, but they are to a very substantially lesser extent.

Senator BOND. What are your views on the ability of the banking and thrift industries to pay insurance premiums as high as 35 basis points?

A lot of people who might now be considering getting into the thrift industry might be discouraged and we might lose some of the potential sources of new capital that would be needed by holding out the threat of the 35 basis point premium.

Is this a valid concern?

Mr. GREENSPAN. Senator, 50 percent is the maximum change in 1 year, a maximum of 35 basis points. That has been undergoing an evolution, but there is a dilemma in this particular issue. The dilemma really gets to the question of trying to give some flexibility to FDIC to maintain a viable fund and some place to go to in the event of losses to be able to recoup and maintain a functioning fund.

The other side of the argument, I think, Senator, is precisely the one you raised, and I am not sure that there is an easy way out of this. It is a tough one.

I think you have to give some flexibility to FDIC in this respect, but you have to cap it at some point.

In other words, the original purpose of putting the cap on was to delimit the flexibility of FDIC in its ability to restore some of the funds. But you are quite right, if you put the cap too high, it is discouraging. If you put it too low, then you essentially eviscerate the FDIC's capability.

Thirty-five basis points I think was a number which everyone recognized was very high, very debilitating, and probably never would be reached, but it was required for the purposes of maintaining some flexibility before the insurance funds' replenishment.

Senator BOND. My point is if 35 basis points really is debilitating and would wreck havoc in the industry, it probably shouldn't even be in there as an option because it could have a chilling effect on getting people in.

Mr. GREENSPAN. It is a legitimate concern. I don't deny that.

Senator BOND. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bond.

Chairman Greenspan, we often get to some of the most interesting things late in the morning. That is sort of the nature of the way these things go.

I want to pursue with you something that I think lies at the heart of where we go from here, settling upon the best plan for the future.

You said earlier in the morning that the interest rate spike of a few years ago and the mismatch between the maturities of the assets and obligations of thrifts was really the critical aspect of what created this problem—and I am paraphrasing.

Certainly, that was a factor, but I want to respectfully disagree with you on that because I think the problem centers more specifically on other problems that developed, and one very specific one that I want to talk about. If there is a fundamental difference in the diagnosis, there may be a fundamental difference in what the remedy is to fix the problem and keep it from happening again.

An assertion that I would make, testing your thesis, is that if you look at the history of the whole savings and loan industry coast to coast, 50 States, over the period of time you will find there are a lot of thrifts that have done quite well. They rode through that situation. It also turns out that there is a high degree of correlation between the thrifts that did quite well and those predominantly centered around the home lending function. We discussed this yesterday with Secretary Brady. Some of the most successful ones—in fact, the majority of the most successful ones—stuck to a fairly narrow home lending charter, and managed to work it out through a variety of ways, not just using adjustable rate mortgages. There are all kinds of interest rate swaps and securitized packages, and what have you, that make it possible to manage in newer ways this interest rate risk problems.

There are a lot of new players who have come into the game. The Ford Motor Co. happens to be one, but a very large, sophisticated public company that feels, for example, that they—and there are others who agree with them—they can come into this business, do the more traditional kind of activity, and live with the so-called interest rate risk because there are ways to cope with it and do quite well.

That doesn't mean they are right, but I think it is a valuable independent viewpoint of some serious people, and as I say, they are not alone.

When you go back and look at 1987 at the thrifts that went in the tank and had to be bailed out, it turns out that 52 percent of the total cost of the thrifts that went bankrupt, in effect, are in two States, California and Texas.

California has 13 percent of the total for that year. We don't yet have full totals for 1988, but we are working on getting those; 39 percent took place in Texas.

Now, it seems odd that we are finding this intense concentration of the failures occurring in certain places. When you start to reach in and see why that is, there are various factors, including regional economic events, and so forth. You also find there is a very high correlation between States that broadened out their State thrift charters and decided to let a lot of higher risk activities go on in their State chartered thrifts, all of this resting on Federal deposit insurance.

I just have to tell you every hour that we work through this thing, that looms larger and larger in my mind as a major as the cause of the overall size of this failure.

Even considering lax regulation and all the other causes, I would say that the pattern of failures points more and more to State powers allowing thrifts to get into risky activities while keeping their Federal deposit insurance as the cause of the lion's share of the loss.

I want to go on from there, but do you have a substantial disagreement with that?

Mr. GREENSPAN. I am not sure. I think we are focusing on two different periods and two different elements.

As I said earlier, I think to Senator Roth, the problem that we had with the expansion of powers is the failure to recognize that with any expansion of powers there is increased risk. Implicit in any expansion of powers should be a parallel endeavor to have increased supervision and regulation because if the expansion of powers is of value, creating economic value and improving the financial system, almost by definition, it exposes the system to greater risk. This doesn't mean you shouldn't do it. It means you should be very careful to maintain the degree of appropriate supervision so that you gain the benefits of the expanded powers.

That was not done.

The CHAIRMAN. I hear that theory. We have since lost $100 billion, largely based on the premise of using that theory. Now, $100 billion has disappeared and we are going through all the pain and agony of figuring out how to put it back in and who is going to pay the bill, and so forth.

I don't understand how we can make any reasonable case for Federal deposit insurance that guarantees that the Federal Government and the Federal taxpayer going beyond what is in a Federal charter for savings and loans and then being stretched out to cover whatever an individual State may wish to tack on as an additional activity.

I think that is just unsound and unreasonable, and I for the life of me can't see why we should continue to do that.

Mr. **Greenspan.** I don't disagree with that principle at all, Mr. Chairman. Take that as a basic principle, and I would think I would certainly support it.

However, the original problems that emerged, the ones that threw us into very serious difficulty in the early 1980's and which, in many respects, led to the endeavors on the part of many States to try to get out of it by expanding powers without the appropriate supervision, was the interest rate mismatch, the maturity mismatch, because in the early period of the 1980's my recollection was that, marked to market, there were probably no thrifts out there who were solvent.

What it is that has happened is that we have translated a mismatch problem, which was severe, into an asset quality problem, and I think there are several principles that we have to learn as a result.

The one you put forth I think is unquestionably appropriate. That does not mean that even if we do that we can have institutions with fixed rate mortgages and short term liabilities. Without some mechanism, as you say, swaps or any variety of things, to delimit the interest rate loss, we will just end up with the same problem.

There are several different things that I think we have to be focused on, and I am merely making the point that the original problem that surfaced was caused by the mismatch, which then translated into the problem that you identified.

The **Chairman.** This to me is a key area of discussion. I want to just take it further before yielding to Senator Garn.

SUCCESSFUL THRIFTS STUCK TO HOME MORTAGE LENDING

When you look at the pattern across the country, there are a lot of major savings and loans in various States, all 50 States, who managed to live through that adjustment process, remained profitable, have high capital ratios, and are in strong condition today. It is very instructive to look at them and see how they managed to come through this period of turbulence and adjustment and unusual situations arising over a period of a decade plus.

The overwhelming majority did it by sticking basically to the housing mortgage function, not by getting out into the high risk, high roller type activities that some States allowed. They have had to devise these new instruments and techniques, such as ARM's, and it appears to have worked pretty well.

We have at the same time managed to meet a lot of the housing need in the country.

But when you look at where the bulk of the problem has arisen and where the $100 billion will go, you find that overwhelmingly the majority of that money disappeared in the States—with these much broader State charters. I don't see why we ought to provide Federal deposit insurance for activities that go beyond what we charter at the Federal level.

I do not understand why we should allow States to add to those powers and put those risks in the future on the Federal deposit system. I just don't think that is right. I don't think it is sound.

And if you agree with that, I think it is important that we hear from you.

Mr. GREENSPAN. I do agree with that.

The CHAIRMAN. I know the former chairman, Senator Garn, has commented on this before. In 1982, in a bill that several of us were involved in and which carries the name of Senator Garn on it, that was one of the issues we raised, precisely what constituted the outer bounds of what ought to be a federally defined charter that would be a 50-State charter.

If you take a look at the history since that time of the add-ons—some people call it the competition of laxity—of States that really went way overboard in terms of creating these additional powers, it seems to me they are the driving cause of the $100 billion loss. Other factors, not enough regulation, not enough people blowing the whistle early enough, fraud, regional economic circumstances, and so forth, were important. But the thing that set us up for the biggest part of the collapse was the Federal Government underwriting those additional activities in those various States. I think we have got to fix that in this bill.

As the bill is written right now, in my view, it does not sufficiently address that issue.

That is a second point, but with that, let me yield my time.

I think Senator Garn may have some questions.

Senator GARN. Mr. Chairman, let me follow along.

Along that same line, I think it is very evident. You referred back to Garn-St Germain in 1982 and getting into direct real estate investments. We allowed 3 percent. Texas allowed 30 percent, and California allowed 100 percent.

I think that tells the story there.

If you look at the so-called massive deregulation in the Federal legislation, it wasn't very much. Ten percent in commercial loans, 10 percent. Three percent in the real estate type. I think the actual numbers make the case that the chairman is making very well.

But I think there is also an answer to that. You follow along with what we did in the 1984 legislation which passed the Senate, but did not pass the House; the 1986 legislation, the 1988 legislation, the Proxmire bill, S. 1886. Every one of those has allowed additional powers for Federal institutions, forgetting that the State-chartered institutions had so-called, "firewalls" and specifically separate affiliates, not even subsidiaries. There was a difference between a subsidiary and an affiliate, and we even went to the extent in some cases of saying that they cannot use the name of the bank.

So the expanded powers were being isolated. As you may remember, Mr. Chairman, they were not covered by Federal insurance even in Federal institutions. They would be in a separate affiliate of a bank holding company and not allowed to have intermingling of funds or depositors' money used in the expanded powers.

I think that is an option to explore—looking at these institutions and saying, all right, if you want FDIC or FSLIC insurance and you want to get into these additional expanded powers that the State legislatures allow you, then put them in a separate affiliate, but you cannot insure those more risky investments.

I think there are ways to do this other than just prohibiting expanded powers, so that you don't eliminate some of the innovation that has come from the States. But I would certainly agree with the chairman—he knows this, we have talked about it for years—that in some way we must segregate those riskier investments and keep them out of the deposit insurance system, not only at the State level but at the Federal level as well.

That is why those provisions are in every one of those pieces of legislation we passed in the Senate but did not become law in the House.

It is late, Mr. Chairman, and I have some additional questions, but I would like to submit them to you for your response in writing.

I would like to make just one brief comment.

Senator Graham from Florida used a phrase indicating the committee in 1988 may have had a "Don't worry, be happy" attitude—using the song that won all the Grammys last night. And in all fairness to the Senator whom I have great respect for, he was not a member of the Senate back in 1985-1986. He was busily engaged in attempting to run a very large State. So I would not expect him to be aware of what we were doing here.

But I can remember Ed Gray sitting there. The worse the crisis got, the more he smoked. It was almost impossible to get him to finish one before the next one started.

He spent a good deal of time warning this committee and was criticized by some as being too concerned, but we had estimates even back in 1985 that the size of the problem was as big as $25 billion. In 1986, the administration asked for $15 billion in FSLIC recap. In 1986, with Chairman Riegle's help, we did pass a clean $15 billion recap.

I wish the Senator was still here because I hardly think this committee, while he was still a governor, was taking a "Don't worry, be happy" attitude. We abandoned all other legislative work from July 1986 until the end of the session in an attempt to approve an unrestricted $15 billion FSLIC recap on the basis that most people felt it was around a $25 billion problem and testimony from the Treasury Department stated that that amount was fine.

I just wanted to correct any impression that this committee was not concerned about that, a considerable period of time before 1988. Indeed, in 1988, in the hearing that the Senator was talking about, GAO estimates were—in May 1988—$25 to $35 billion. FDIC said it was $20 to $60 billion. Mr. Silverberg said $50 million, Greenbaum $25 to $50 billion.

So I think we were aware of the problem and had been for some time.

The sin comes in not having done something about it, not that we were not made aware of it. And I am still, to be very candid about it, very bitter at the House of Representatives for what they did in October 1986, when not only would they not grant new powers but they also would not pass the $15 billion of FSLIC recap and even refused to extend the expiring powers of title I and title II of Garn-St Germain, which were the emergency powers granted in 1982.

So we left session not only not granting new powers, no additional funds, but took away the powers they had had in existence, and it was nearly 11 months later before we passed $10.8 billion and only allowed $3.3 billion of that to be spent per year.

So there is plenty of blame to go around, but I can't resist continuing to dump most of it on the House of Representatives in October 1986. [Laughter.]

I will submit the rest of my questions for your response in writing.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Chairman, I have four things I would like to cover as quickly as I can.

I appreciate your patience today.

Yesterday Secretary Brady really stressed the fact that we need the savings and loan industry because of its housing function and the value of that to the country and that we needed to preserve the system and strengthen it for the future. I want to give you two statements from his testimony yesterday.

Some of this was said earlier in the morning, but I want to put it in at this point and then pose a question to you. He said:

> Never again should the Nation's savings and loan system, which is important to our commitment to available affordable housing, be put in jeopardy.

And even further back on page 12 of his testimony, he said:

> The administration's plan is designed explicitly to promote housing finance by revitalizing the S&L industry and the Federal Home Loan Bank System. We believe the best thing for housing finance in this country is a strong and sound S&L industry.

So there was no halfway statement.

What he was saying is that this is a valuable industry, with a specialized purpose. We are going to make it stronger, and we see this industry out there for the long run, years and years and years presumably into the future.

Now, there is a view expressed by others that says, well, that may be what is said and may be even an accurate reflection of the view of the administration. There are others who would be part of the brain trust of people who put ideas in, including the Fed maybe and others, who perhaps have a very different view on that issue, who question fundamentally the importance of the savings and loan industry.

Does it need to survive as a specialized home lending facility into the future? Are we not, because of lots of changes domestically and internationally, moving into more and more a kind of unitary financial services system, where whatever differences there are between the banks and savings and loans would be erased and maybe you would actually even see the S&L industry disappear?

He was very firm yesterday about his view and the administration's view of the importance of maintaining the industry as a freestanding entity for housing.

Do you hold that view?

Mr. GREENSPAN. Well, Mr. Chairman, I think that ultimately it is going to be the markets which are going to determine the financial structure in this country.

I personally believe, and I think most analysts who do look at this in some detail see that there is a valuable place for a mortgage-specialized institution, and as I said in earlier remarks, I think that those institutions would exist to originate, service, and hold mortgages, whatever your legislation, unless you just outright prohibited them.

What I don't think is likely to be seen in the future is the type of thrift institution which exists only in the context of a very stable financial environment, which is one which did so well and in fact contributed very materially to this nation's well-being when interest rates were low and inflation was virtually nonexistent and you could hold long- term assets and fund them with short-term liabilities.

I don't believe that that type of institution can exist in the future.

What I do believe is that you can have a specialized mortgage institution with very sophisticated techniques of the type that you suggest, Mr. Chairman, which will ameliorate the mismatch between assets and liabilities, will be a profitable institution and will essentially capitalize on the fact that there are certain basic economic values that can be created from local knowledge, the same reason that we have got small community banks which can out compete some of the larger ones. Local knowledge and expertise is what I, think will continue to support these institutions—I don't even know what I would want to call them—but specialized mortgage lenders will exist because they are profitable.

I don't think that it is going to matter all that much what type of institutional structure we put around it because if the market says they are profitable, they will flourish.

If the market says they aren't, I don't care what we do, they will die.

The CHAIRMAN. Let me suggest a name to you, and one of many that might be suggested if we are going to get into the naming business.

That would be to call these institutions national housing banks, off a Federal charter, with housing as the primary focus and some wrap-around of sensibly related activities, and so forth.

There is a related question that I really want to ask you to address head-on, if you will.

Do we have in place now with the savings and loan system, not just all these institutions out there, some insolvent, some struggling, some well, in strong shape, and so forth, but all of them having this geographically dispersed character?

They are in all the communities across the country. They know those local markets and make those loans, and I think, as you have said twice now, that there is a value to that, and I agree there is a value to that as well.

But there is a big difference between whether we structure a plan here that slowly dismantles the system, the specialized housing system that is there, because it isn't just the individual savings and loans, it is the Federal Home Loan Bank System. It is those regional banks out across the country.

And I think we have got to build into this legislation a fundamental premise that says we are going to go with that system for the long term and we are going to strengthen it and revise it and structure it and put it into the supervisory relationships with others that really gives it a good long, strong run into the future, or we are going to do this in such a way that we are going to recognize that things are so dynamic that maybe this whole system is for a specialized housing purpose and maybe outliving its usefulness for a lot of reasons and that in fact it may come apart and it may break up. Parts of it will survive under a different name in a different form. Maybe some become commercial banks, and so forth.

I think that is a very critical difference in path into the future, and I think, depending upon what our conception is, we can construct one kind of a plan to accomplish one goal.

If in fact the general view or the professional view would be that you have got to accommodate to a different set of realities, then the plan really becomes quite different, and I think the costs are very different.

Now, if you would respond to that. Are you clear in your mind that—if that is sort of a fair way to perhaps put that kind of a hypothetical question, that you are clear in your own mind as to which of the paths we ought to take here?

Mr. GREENSPAN. You phrased the question, I think, precisely the way it should be phrased. I don't think that question has to be answered now, nor should it be.

I think that that is fundamentally why the Treasury study about this whole system is desirable, because I would move toward the study in an endeavor to answer that question, which is very crucial to the financial structure of this country over the long-run.

I don't think that decision should be made on narrow grounds. I think one should think about what it all means and whether we want to go in one direction or the other.

I view the legislation which the Treasury has brought forth as not addressing that question because I think you would probably go with the Treasury approach either way, and I don't think it actually matters. It doesn't prejudge the conclusion of that issue, but I would say that you have delineated precisely the way the focus of this study should go.

It may come out somewhere in between or on either side as the most appropriate national policy for this country.

If we go back to the original questions of, do we want to foster homeownership, how much do we, what is the cost, what are our demographics—because clearly we have a different type of demography in this country than we did a long time ago—we should be very clear as to precisely what it is we wish to do.

Having done that, we can then focus on precisely how we wish to fashion the mortgage market as far as governmental actions are concerned and what types of institutions essentially support the mortgage market.

I think it would be a mistake to start and say, let's have either a sort of homogenized depository institution system where everybody is the same or specialized institutions of some particular type.

I think that is basically making a judgment far ahead of the facts, and I would myself feel quite uncomfortable in moving in either direction short of a really substantial study directed according to the way you have raised that question.

The CHAIRMAN. I appreciate your answer and the complexity of trying to provide an answer to that question.

I want to say one other thing before yielding to Senator Graham here, and that is this.

This gets compounded by the fact that we are about to ask the American people to sign up for a very big expense that is now inescapable. We are going to use a variety of financing mechanisms to make it look perhaps less onerous than it is, but we are going to sign the public up because we are standing behind the Federal deposit guarantees to spend several tens of billions of dollars, maybe as much as $100 billion, just from the public before it is over.

There are different estimates. Senator Heinz has come up with an estimate that puts it in that range, or higher. It seems to me that the public is beginning to understand the dimensions of this problem and the fact that the cost of it largely is falling back on them. I think their frustration about that is rising along with their realization that they are going to have to pay for a large part of it, that they are going to have to give something else up in order to pay for the solution to this problem. I think the public increasingly wants a sense as to whether this investment, even though it is to pay for past mistakes, is really being done in a way that is going to give us a system in the future that makes sense and that is going to be sound and will not come back in this form again and meets an important purpose that they care about and that serves their interest, the public interest. If we can't make that finding and that demonstration to people, I think an awful lot of people out there are going to want to say we want no part of this.

When you add that dimension to it, I am not sure that we have the nice, easy choice of saying let's make today's decision today and at some point down the way we will really make the fundamental decision as to whether or not this industry has a specialized value to it and whether we really ought to strengthen it in a way where it goes on for a long period of time.

The Treasury yesterday quite clearly said that they have made that decision. Now, maybe they didn't mean it quite as strongly as they said it, but I just quoted you the words so you could get the flavor of the intensity of the commitment that they were making.

So I think the Treasury Secretary was saying yesterday we are going to build a system that is a specialized housing system and we are going to put it on a sound footing and it is going to be there for many years to come and you can just hang your hat on that.

It sounds to me like in your mind you are saying that perhaps the way this really ought to be viewed is we are not yet to the point where we can really make that decision.

I would just note that you are sort of nodding quietly in the affirmative. [Laughter.]

Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman. I have a couple of areas that I would like to conclude with.

One is the issue of brokered deposits. I don't know if this rumor can be validated, but there was a representation made that the Home Loan Bank Board was about to take steps to severely restrict brokered deposits and the Treasury intervened and cut off that Home Loan Bank Board initiative.

I would like, Mr. Chairman, to see if we can determine if that is factually correct. If it is, that would add another concern of mine to the issue of independence of the Home Loan Bank Board from the Treasury.

Obviously, substantial amounts of moneys have been made through the brokered deposit transactions.

Was it considered as to whether there should be any way in which those transactions should carry part of the financing of this solution, some surcharge or other imposition?

Mr. GREENSPAN. On brokered deposits per se?

Senator GRAHAM. On brokered deposits.

Mr. GREENSPAN. I frankly don't know, Senator. I would suspect not, because it is fairly obvious that if we put any type of premium on them or any type of fee, we very likely would put them out of business because obviously there has to be a very narrow margin in this type of operation.

Senator GRAHAM. That is a creative suggestion maybe as to how the problem may be solved.

Mr. GREENSPAN. Frankly, I don't know whether or not this issue was contemplated in the early stages of discussion. When I was involved in it, I never heard this issue come up.

Senator GRAHAM. One other suggestion that has been made relative to how to deal with brokered deposits is a differential in insurance premiums based on that portion of the institution's funding base which came from other than the direct depositor.

Would you have any thoughts about the general idea of allowing for differentiated insurance premiums based on standards of risk or sources of funds and any specific comments as to its application to brokered deposits?

INSURANCE PREMIUMS BASED ON RISK

Mr. GREENSPAN. It sounds like a very tough thing to try to put into place. This is the same issue that you have all been discussing as to whether or not the deposit insurance should be on the deposit or on the individual, and obviously if you wanted to eliminate brokered deposits, if you went to $100,000 limit to an individual as distinct from the deposit, then brokered deposits would fall by the wayside.

To the extent that you endeavor to do anything in between, as to what would in effect occur, I would suspect you probably would eliminate the brokered deposit business one way or another.

By making significant differentials you would probably essentially outlaw brokered deposits. If that is the decision, then you might as well do it directly.

Senator GRAHAM. Let me ask for the record what is your policy recommendation as to brokered deposits.

Mr. GREENSPAN. I have not really come to a strong conclusion. I feel uncomfortable about brokered deposits. I think that they were a material factor in the problems we have come to, but they have also been a vehicle to improve the liquidity of the system and they have had other advantages.

As I was trying to say to Senator Kassebaum earlier, I wish I could think of a way in which we could maintain some of the obvious liquidity advantages of brokered deposits without some of the obvious disadvantages that we have seen, and I suggested that should be one of the elements in the study which is now currently contemplated as part of this whole process set in motion by the Treasury Department.

Senator GRAHAM. Mr. Chairman, I have one last question which relates to some comments on page 15 relative to what I believe is known as regulation Y within the Board.

On page 15 you discuss your thinking regarding the changes to regulation Y which would assert that subsidiaries in State banks are subject to regulation by the Federal Reserve Board pursuant to the Bank Holding Company Act.

I also understand that it is the Board's position that all the banks' nonbanking activities would be done in separate subsidiaries.

This would appear to limit State bank activities to those permitted under the Bank Holding Company Act. The effect would be to federalize bank powers and limit States' authorities to grant powers to those permitted under section 4(c)(8) of the Bank Holding Company Act.

With that premise, would not the actions that the Board is considering adversely affect the dual banking system and, if you do not believe it would do so, what role do you believe is appropriate for States in granting powers to banks?

Mr. GREENSPAN. Senator, that is an issue which is under very significant discussion and dispute. It has been a long held view of the Federal Reserve that in order to protect the safety net it would be desirable to move in this direction.

It is the view of the Board basically that this would not do damage to the dual banking system, which we all hold as an important value of the system, but we are concerned about the Federal safety net. That is an issue, as you are aware, which is under considerable debate, and hopefully we will be able to find a solution which satisfies both ends of this problem.

Senator GRAHAM. In this debate do you foresee circumstances under which State banks would be allowed to exercise powers other than those granted by Federal law and, if so, what would those circumstances tend to be?

Mr. GREENSPAN. Senator, I would like not to prejudge this discussion, largely because I think there are so many different issues that are involved that I would prefer to remain mute, if I may, for the moment.

The CHAIRMAN. A last question from me, Mr. Chairman. I am concerned about the reports of sharp increases in deposit rates in thrifts in Texas and elsewhere. The jump-up in interest rates was sudden. Apparently the competition became so intense in some areas it was literally raising the interest rate by the hour in competing depository institutions.

Does this appear to be a case where insolvent institutions are paying higher and higher rates to attract deposits and may well be creating a further expense for us down the line when they are liquidated, or are these rate increases being led by healthy institutions? If so, why would that be happening?

Mr. GREENSPAN. We don't know the answer to that yet, Senator. However, we have been watching it very closely and trying to find the answer to precisely that question.

The phenomenon is very obvious. There are lots of different explanations of why people think that is occurring. We don't yet know the reason, but we are working on it, and hopefully we will come up with some explanation of what this particular process is, and when we do, we will certainly make you apprised of our study.

The CHAIRMAN. We would appreciate that.

Earlier you said that there may have to be some midcourse corrections in this plan. Presumably there will be after it is legislated, and we certainly envision that that will be the case no matter how we write the plan.

Today the staff of this committee was tentatively increased partly for that purpose, so that we can do that rather extraordinary oversight job in the future, not just get it written now but to make sure that what we put in place is working the way that it was anticipated, or, if adjustments are needed, they can be made.

So I wanted to assure you that we are going to do the oversight job here in a very intense way along the lines that you yourself described earlier.

My last observation is that one of the things that comes out of our hearing today is that in this bill that came up from the administration yesterday, 333 pages, the study which comes on page 328, near the end, is by no means just an afterthought.

I think our discussion indicates today that that piece of work, as it is contemplated, is a pretty serious part of this proposal, and I think it is useful that that be out on the public record so that everyone can take account of it.

I want to thank you for your patience today and for your excellent testimony. It was greatly helpful to us, and we appreciate it.

Mr. GREENSPAN. Thank you very much.

The CHAIRMAN. The committee stands in recess.

[Whereupon, at 1:10 p.m., the committee was recessed, to reconvene on Tuesday, February 28, 1989.]

PROBLEMS OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC]

PART II OF IV

TUESDAY, FEBRUARY 28, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m. in room SD–538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Sarbanes, Dixon, Shelby, Graham, Kerry, Bryan, Garn, Heinz, D'Amato, Bond, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

We want to welcome this morning two major witnesses in our continuing work on the savings and loan FSLIC issue.

Today marks the seventh day of our hearings, and we want to welcome the Chairman of the Federal Deposit Insurance Corporation, William Seidman, and later on in the morning we will hear from Comptroller of the Currency, Robert Clarke. These are important witnesses, and we very much welcome their testimony.

I want to indicate that today in the Senate there are a number of other activities going on literally at the same time. The Tower nomination has required many people to be over examining FBI material in the Capitol, and so, some of our colleagues have indicated to me that because of the press of that requirement that they would not be here until later in the morning.

We also have Chairman Greenspan appearing before the Senate Budget Committee this morning. A number of our members here are members, as am I, and so we will have members coming and going in the course of this morning.

I want to just make a brief opening statement. Under the administration's proposal for handling the problems of FSLIC, the role of the FDIC will be greatly expanded. Chairman Seidman would be placed in charge of deposit insurance for thrift institutions and the FDIC would be given strengthened regulatory authority over the industry.

In the past I have emphasized the following concerns with respect to the administration's proposal. One, the financing mechanism proposed may not be the least expensive and most responsible alternative from the taxpayers' point of view. We are looking at that very carefully.

The proposal does not adequately define what a future thrift charter or a national housing bank charter—language of my own—should look like and how we resolve the conflict of State powers that go beyond what the Federal charter directly allows and yet are nevertheless covered by Federal deposit insurance.

A third point along the same line, the administration proposal does not address what powers should be allowed a thrift institution covered by Federal deposit insurance except to leave that decision up to the new FDIC. This, again, relates importantly to the State issue but in effect it goes beyond that as well in terms of the degree of latitude on judgment in that area.

The concern I have is that regulators come and go, and every once in a while we get a good one, as we have at the table right now in Bill Seidman who I think does an outstanding job. But that has not always been the case nor will it be the case in the future. I strongly feel a fundamental policy decision should be made by the Congress as a matter of law certainly with respect to the broader decisions and not by a regulatory agency, no matter who might be heading it at a particular time.

This morning I want to raise another concern. A number of commentators believe that the administration proposal places too much authority in the hands of the Treasury Department. Whether Republican or Democratic administration, these people argue that what this plan does is to in effect create a ministry of finance out of the Treasury Department with too much centralized and concentrated power in the hands of too few people. And important members of this committee have expressed that concern in their own language.

I share this concern with respect to the independence or lack of independence of the proposed new FDIC, so we will be examining and judging that issue very carefully.

Because Mr. Seidman has a distinguished accounting and financial background prior to his time in government service, I have also specifically asked Mr. Seidman in writing today to comment and diagram for the committee the Treasury's indirect financing package versus what might be considered a simpler and more direct financing alternative. So we have both of those here today at my request, and I appreciate the work that was done to produce those.

Finally, when Alan Greenspan, the Chairman of the Fed, was here last week before this committee he indicated that handling the thrift problem in Texas would cost around $40 billion just in that one State. He made the following comparison with respect to banks in Texas, saying:

> In that State where the economic environment for banks and thrifts is identical, the cost for resolving the problems of the banking industry with assets that are much larger than those of the thrift, that the cost for resolving the bank problem should amount to considerably less than $10 billion.

He concluded:

> Clearly, the large absolute difference in cost and the even larger differential in cost relative to assets is evidence that the thrift industry experienced a systems failure. That is a major lapse in public and private prudential standards.

I think that's one of the most potent comments we have received really from anybody in terms of describing the worst of this problem as it's developed around the country.

I would hope today, Mr. Seidman, that you would explain for us why the regulatory system worked more effectively in the banking system in Texas, albeit with some problems, than we have now found to have been the case with the regulatory system that was in place for the savings and loan system. Why this profound difference in terms of the breakdown of one S&L banking type system versus a markedly different performance in the regular banking system?

With that, let me yield to my colleague, Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

Chairman Seidman, we are happy to have you before us today and I will not take long.

The major point I want to make is one that both Chairman Riegle and I have been making since the outset of these hearings, that we do have a basic plan before us, and we must move FSLIC legislation through the Congress as quickly as possible. The crisis demands immediate action and so does the American public.

I have no doubt that the committee and the Congress will want to put its stamp on the legislation and make some changes, and I think we should. There are some differences that I've pointed out that I have with the President's plan, but I don't think we have to waste time doing that. Thanks to Chairman Riegle's compressed hearing schedule and his hard work in moving these proceedings along rapidly, the key issues are emerging very quickly. I say that we examine them, offer amendments and vote. The process is just not that complicated when we summon the will to vote and make decisions—that is exactly what we need to do and I believe we will on the Senate side. I have some concerns about the House. Maybe that's because after 15 years of seeing things passed on the Senate side that the House doesn't do anything with, you sort of get conditioned to the fact they don't move very rapidly.

Let me explain why I harp on this point so much. I'm beginning to sense that those who would like to see this legislation delayed are seizing on normal congressional analyses and criticisms as an excuse to slow everything down. That's a normal game we use, too. Study it, think about it, we've got to be careful. No one has mentioned the terrible word yet—forbearance—but it's clearly in the air and I just want to note for the record that forbearance is one of the main reasons that we're in this mess and I can't believe that anyone would want to go down that road again.

There's been particular confusion about the new capital standards that will apply to thrifts in 2 years. If a thrift fails to meet the standard but still has a substantial positive net worth some critics say the FDIC will be forced to liquidate an institution or to force a merger. I've been told over and over again that the answer to that question is definitely no. The FDIC will have the authority to stop the institution from growing and monitor activities more closely, but there is no cliff they fall off at the end of that point.

Critics maintain that the answer is yes, the administration proposal is really some sort of secret plan to eradicate the thrift industry. I think that's just plain wrong. I hope the witnesses will clear this matter up once and for all today. There certainly is no secret plan and none of these things should be used as an excuse to slow the process down.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Garn. I want to make a comment about your scheduling question or comment, but let me call on Senator D'Amato.

Senator D'AMATO. Mr. Chairman, thank you, and let me compliment you for moving these hearings so that we can hopefully address this problem with the legislative approval that it will require and those amendments that Senator Garn spoke to.

I'd like at this time, in addition to welcoming Chairman Seidman, ask him and the Comptroller if they might not comment—I'm not going to be able to be here because we have a heavy schedule of other hearings, but there is a certain problem that I see. It may not appear to be monumental, but I think it's important as it relates to the restructuring of the credit union insurance fund.

Mr. Chairman, for the life of me, I don't understand why this fund is being melded in, so to speak. It's in good shape. I am not going to take the time of this committee to read my prepared statement. I'm going to ask that it be included in the record as if read in its entirety.

The CHAIRMAN. Without objection.

Senator D'AMATO. I would say that the National Credit Union Insurance Fund has a reserve ratio which is 1.3, a figure which is approximately 50 basis points above the long-term goals of the Treasury. There's an old saying, "If it ain't broke, don't fix it." This isn't broke. If anything, maybe that insurance fund should be used as a model or as a guide. And I would offer this, that I am certainly going to move and would hope that Treasury, after looking at this would reconsider its position, and I would hope that other members of this committee and the Senate would join with me in looking at this matter because it certainly does not appear to be something that is going to help the credit unions which are owned and operated by the members, are not for profit, are much more conservative, affect millions of people, and I don't believe should be put into this amalgam. So I would hope that we would look at that and I mentioned it to the chairman. I think it's something that certainly I would be desirous of getting your comments on.

[The complete prepared statement of Senator D'Amato follows:]

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I am pleased to once again welcome Comptroller Clarke and Chairman Seidman. However, I am particularly concerned about one aspect of the administration thrift plan which Mr. Clarke and Mr. Seidman may, or may not support. This problem is the plan's restructuring of the credit union insurance fund.

In short, the inclusion of the credit union fund in this FSLIC deficit plan is ill-advised. I am puzzled as to how this provision came to be included in this program. It is true that the credit unions have a deposit insurance fund; however, in substance, any similarity between credit unions and the institutions insured by the FDIC and the FSLIC ends there.

Credit unions are very conservative, member owned, nonprofit institutions. The credit union insurance fund is not now and has never been insolvent, nor does it present a current risk to the Federal Treasury. Indeed, while the FSLIC is insolvent and the FDIC sits at a record low in reserve ratio, the NCUIF reserve ration is at 1.3 percent—a figure 5 basis points above the long-term goals of the Treasury plan for the FDIC and FSLIC. There is a familiar rule that applies here: if it ain't broke, don't fix it.

In fact, as is usually the case when a nonproblem is addressed, the so-called solution makes matters worse. The NCUIF would actually be weakened by this plan because the superior self-insurance aspects of the credit union movement would be replaced by yet another government-controlled fund. Furthermore, for less protection, the credit unions would actually be required to pay more. If it is important to make all the deposit insurance funds look the same, we would do better to use the credit unions for a model. The credit uinion fund is most solvent and the credit union movement has GAAP capital already exceeding the goals which the Bush plan sets for the thrift industry.

Of course, analogies of the banking or the thrift industries to the credit union movement always limp because they are fundamentally different enterprises. For this reason the plan's treatment of the NCUIF is improper; moreover, inclusion of the NCUIF in this plan is improper. I feel confident that once the Treasury is fully informed as to the facts of the NCUIF, it will drop this issue from its plan. I look forward to seeing a reconsidered version of the plan in the near future.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator D'Amato. I appreciate the point that you make on that.

If I may make one other observation before calling on Chairman Seidman in reference to what Senator Garn said earlier. First, I appreciate your generous personal comment that we're going to continue to move at a very fast pace because the problem requires that. We will complete our hearing schedule on March 17, and we will have heard from all of the major participants at that time. Then, it will be the intent, as I've said before, for us to begin an active process within the committee of drafting the bill over the Easter recess period—hopefully with a consensus. I think we can get quite a long way down that line. If we have some major differences on critical points, we will have to bring those forward and vote them, but my hope would be that we could have a very substantial consensus around the essence of the bill that we will produce.

I agree with what Senator Garn has just said, and I think we can make some adjustments here and there as we need to in the administration plan, but in a very rapid order bring that bill to the committee here for action, mark it up, and then seek from Majority Leader Mitchell the earliest slot on the Senate floor so that we can take the bill from the committee and get it into the business flow on the Senate floor almost immediately.

Now with respect to the House, I want to say one thing. I've spoken with Chairman Gonzalez and with Subcommittee Chairman Annunzio. These are both colleagues with whom we have all worked for many years. They share the same sense of concern about this problem as we do. They are moving ahead and I've indicated to them our desire to want to work cooperatively with the House because we both have to move through this problem simultaneously, and I feel that we will be able to do that. I feel that the cooperation that we will have back and forth with the House will be good cooperation and I am encouraged by that. Obviously they've got to make their own judgments and they will, as must we, but I think that we will find ourselves moving along pretty much in tandem. I think that's an encouraging sign.

With that, Chairman Seidman, we would be very much pleased to hear your statement now.

STATEMENT OF L. WILLIAM SEIDMAN, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. SEIDMAN. Thank you, Mr. Chairman, Senator Garn. Thank you for asking me to testify today concerning the resolution of the problems facing the S&L industry and FSLIC.

The FDIC supports the President's recently proposed legislation that was introduced as S. 413. We believe it is sound, constructive, and a farsighted proposal that should be enacted promptly.

In its most fundamental components, the bill and the recommendations made in the FDIC's recently released study are on all fours. They provide for the independence of the thrift insurer, enhanced deposit insurance revenues, better control by the insurer over those revenues, and additional tools to better control the insurer's cost.

With respect to the independence of the insurer, the President's proposal would separate FSLIC from the Federal Home Loan Bank Board and consolidate it with the FDIC. While providing a single management and administrative structure, it would maintain the FDIC and FSLIC funds as separate insurance pools.

Making the thrift insurer independent is sound policy in any legislative package. From an agency point of view, the FDIC may have preferred to see FSLIC separate from the FDIC. However, in terms of staff time and cost, the administration has determined that an administrative merger of FSLIC into the existing insurance structure at the FDIC is more cost-effective. Therefore, we will work diligently to ensure that result.

With respect to enhanced revenue provisions, S. 413 establishes a new insurance premium structure that appears viable for both the FDIC and the FSLIC insurance pools. The insurance premiums paid by banks would increase to 12 basis points in 1990 and 15 basis points in 1991. Premiums paid by thrifts would remain at 20.8 through 1990 and increase to 23 basis points for 1991 through 1993 and then drop back to 18 in 1994.

Furthermore, the FDIC would be provided with flexibility to raise the premiums above those levels under extraordinary circumstances and to rebate assessments once the fund exceeds target reserve levels.

The proposed new bank premiums are reasonable and similar to those recommended in our study. The FDIC also believes the premiums charged to FSLIC-insured institutions are both reasonable and apparently within the capacity of those institutions to pay. But, there should be careful consideration of the effects of the premium level on the industry's viability when coupled with significant increased capital requirements, goodwill writeoff, and a loss of income from the Federal Home Loan Bank System.

This is a complex question which requires flexibility on the part of the insurer.

We believe it is most important that the cost of resolving the S&L situation be borne to the greatest extent possible by that industry. Just as importantly, as provided in the bill, the banks are not to be called upon to bear any of the cost of the S&L problem.

Improved provisions to control cost. The President's proposal goes a long way in providing the FDIC with the necessary tools to control costs. The FDIC would be able to deny insurance coverage to any S&L, both State and Federal. In addition, while insurance for national, State and Federal member banks would continue to be automatic, the OCC and the Fed would be required to consider a new and additional standard—risk to the deposit insurance fund—before granting a national bank charter or Federal Reserve membership.

The FDIC would be provided with the authority to immediately suspend deposit insurance if an insured institution has no tangible shareholders' equity. The FDIC would also be able to promptly remove insurance from any insured institution that is engaging in unsafe or unsound practices, operating in an unsafe or unsound condition, or otherwise causing undue risk to the insurance fund.

Under current statutory procedures, termination proceedings can take from 2 to 3 years. Under S. 413, revocation would normally occur within approximately 6 months.

The FDIC would be provided with the tools to examine and assess risks in thrifts. Upon notification to the FHLB's, the FDIC could examine any insured thrift for insurance purposes. This is the same as the FDIC's current authority with regard to national banks and State Fed member banks. However, since in the past there has been some question about the FDIC's authority to examine independently such banks to protect the insurance fund, the FDIC should have clear legislative history on this point.

S. 413 appropriately applies bank-like regulatory standards to thrift institutions. The FHLB's would be required to establish capital standards that are no less stringent than those for banks—to be fully implemented by June 1, 1991. If an institution does not meet those standards, the FHLB's would be required to prohibit growth by those institutions. Thrifts would have 10 years within which to amortize their goodwill. Thrifts would also be required to conform to bank accounting and disclosure standards.

But let me make it clear here in accordance with your statement, Senator Garn, that this does not require automatic failure of thrifts if they do not meet the standards. That discretion is left with the insurer as it is with banks at the present time.

The FDIC would have additional risk-reduction authorities under S. 413 relative to thrifts that it does not now have explicitly—and would not be given under S. 413—with respect to banks. Specifically, the FDIC would be able to prohibit or restrict the growth of assets by a thrift institution that does not meet minimum capital standards established by the FDIC.

Furthermore, the FDIC would have explicit authority to determine that State-authorized activities that are not permissible for federally chartered S&L's pose an undue risk to the insurance fund and to require that the thrift cease conducting those activities within the insured entity itself. And that addresses the chairman's comments and concerns in that area.

S. 413 also takes steps toward expanding the pool of private capital that would be available to rescue the thrift industry. First, additional nonbank holding companies may be interested in acquiring thrifts once the cross-marketing and tandem operation restrictions of the CEBA are lifted. Second, 2 years after enactment, bank holding companies also would be permitted to acquire healthy thrift institutions without the imposition of the tandem operation restrictions now imposed by the Fed.

In our view, any acquirer of a thrift should be able to operate a thrift as a thrift without any special restrictions.

S. 413 also contains the fund indemnification provisions that the FDIC believes is vitally important in dealing with failed insured depository institutions that are commonly controlled. In effect, it provides a cross-guaranty among the insured institutions so that some of the institutions will not be allowed to fail and others to walk off with the good business of the holding company.

Budgetary impact of the problem. With respect to the size of the problem and the financing proposal, reliable cost estimates resolving the insolvent S&L's should be made by on-site examinations. We are in the process of making such estimates pursuant to the joint oversight effort announced by the President on February 6, 1989. Our best estimates at this time are in the same range as the Treasury Department's estimated costs, but we have not yet received any results from those examinations.

Regarding the financing package, the Treasury and OMB are in the best position to comment. From our viewpoint, the President's proposal, while complex, appears viable and sound. In accordance with your request, Mr. Chairman, we have brought charts that show the sources and uses of funds under the proposed financing package [indicating], and the uses of funds under a proposed financing package which would be based on the direct financing approach. That is this chart on this side over here [indicating].

As might be expected, S. 413 is not perfect from the FDIC's perspective. Clearly, some compromises had to be made along the way. In our view, none of these compromises undermines the essential soundness of the proposal. However, there are a few changes we would recommend to the committee.

First, S. 413 would make changes to the existing independence of the FDIC and would limit that independence. It would permit the President to appoint and remove with or without cause the Chairman and Vice-Chairman of the FDIC Board. Such removal authority could compromise significantly the independence of the FDIC and we would recommend that it be deleted. If a change is needed, we would suggest that a system similar to the Federal Reserve System be adopted, namely appointment for a term with the consent of the Senate.

Another provision of S. 413 would place complex limits on the FDIC's borrowing authority. Let me make it clear. We believe it is appropriate to limit the FDIC's ability to issue notes and other debt obligations, but the proposed limitations would seriously undermine the safe and cost-effective operation of the insurer beginning as soon as it is enacted.

We would recommend a very simple borrowing limit: No notes or other obligations can be issued which would put the agency into a deficit net worth position. Thus, the FDIC could not issue debt if it does not have its own resources to repay that debt and could not obligate taxpayer funds.

S. 413 also would require the FDIC to submit quarterly financial reports to both the Treasury and OMB. It would seem sufficient and less costly to file such reports with the Treasury and the Treasury could handle the matter for the rest of the administration. The reports, we believe, should be those prepared by the FDIC in the ordinary course of business in order to cut down on paperwork.

I would like to submit language for the record to remedy the proposed legislation in each of these important independent areas.

The CHAIRMAN. Very good. We will make that a part of the record and we appreciate having it.

Mr. SEIDMAN. Thank you.

Second, while S. 413 would allow the FDIC to require that a thrift cease a risky activity, it does not specifically authorize the FDIC to establish appropriate firewall safeguards against those activities that are moved to a subsidiary or an affiliate. We believe this additional authority is very important and are submitting for the record some suggestions for such authority.

Let me emphasize that as we narrow what can be done in a thrift or an insured bank, we will be running into broader authorities provided by the States. We believe it is appropriate to narrow those authorities in the insured institutions, but for the overall institution to be viable economically many of those powers could be exercised in a thrift subsidiary safely because the bank or the thrift would be protected in case they fail. And I think this is going to become a very important issue as we discuss this legislation and it proceeds through the Congress. Of course, that raises the additional question of whether that subsidiary can be regulated by the Federal Reserve or not. We do not believe it should be.

Finally, S. 413 should be amended to permit bank holding companies to acquire failed or failing S&L's immediately without cross-marketing activity and branching restrictions or any other restrictions that have been routinely imposed by the Fed. These restrictions unwisely curtail the acquisition of thrifts and thus increase the FDIC's cost.

In conclusion, while we know this committee is acutely aware of the need for expeditious legislative action, we would like to put our weight behind that point of view as well. Every day that we wait, the problem will become worse. Nothing of major substance can be accomplished to correct this problem until the Congress acts to provide funding and guidance.

We will be happy to work with the committee and I am prepared to answer questions.

[The complete prepared statement and addendums of Mr. Seidman follow:]

TESTIMONY OF

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

ON

RESOLUTION OF THE PROBLEMS OF THE SAVINGS AND LOAN INDUSTRY
AND THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

9:30 a.m.
February 28, 1989
Room SD-538, Dirksen Senate Office Building

Good morning, Mr. Chairman and members of the Committee. I am pleased to testify today concerning resolution of the problems facing the savings and loan ("S&L") industry and the Federal Savings and Loan Insurance Corporation ("FSLIC").

FDIC SUPPORTS PRESIDENT'S PLAN

The Federal Deposit Insurance Corporation ("FDIC") generally supports President Bush's Reform Plan for the savings and loan industry, announced February 6th, and the recently proposed legislation -- that was introduced last week as S. 413 -- to carry out that plan. We believe it is a sound, constructive and farsighted proposal that should be enacted. S. 413 provides for prompt action to resolve the S&L situation and proposes structural and regulatory reforms designed to make the federal deposit insurance system cost-effective.

Our only reservations concern a few of the provisions relating to the independence of the deposit insurer. As pointed out below, these proposals unfortunately would hamper the FDIC's ability to perform, at the very time it is being asked to undertake major new responsibilities.

We now will address the key issues raised in the Committee's letter of invitation. First, we will describe the FDIC's recommendations for structural and regulatory reforms to the deposit insurance system and our views on the reforms contained in the proposed legislation. Then, we will address the size of the problem and the Administration's financing proposal. Third, will be background information on the interagency oversight effort with respect to insolvent S&Ls. And, finally, we will address the question of the need for a separate thrift industry.

STRUCTURAL AND REGULATORY REFORMS

It has become clear that changes must be made to the federal deposit insurance system to ensure that it is cost-effective and self-financed.

During the past year the FDIC has examined ways to improve the federal deposit insurance system. The product of that review -- our recently released study Deposit Insurance for the Nineties: Meeting the Challenge -- contains numerous recommendations for reform. A copy of the study's Executive Summary is being submitted for the record. A draft of the complete study has been provided to each member of this Committee previously.

The FDIC study sets forth certain principles necessary for a sound deposit insurance system for the future. The first principle is that the deposit insurer should be organizationally and financially independent. Thus, the insurer should be empowered to operate, as nearly as possible, like a private insurer. In accordance with this principle, the insurer needs control over its revenues. Also, the insurer must be given the basic tools necessary to control costs. These requirements will be elaborated upon below.

1. Independence of the Insurer

The FDIC study recommends that the federal deposit insurer be made as organizationally, operationally and financially independent as possible. To guard against conflicts-of-interest, the insurer should not be under the control of a chartering authority. Translated in terms of the issue facing the Congress today, this means the FSLIC should be separated from the Federal Home Loan Bank Board. In fact, in the three alternative plans for agency

structural reforms set out in our study, the one constant was that the FSLIC was to be separated from the Bank Board. The FDIC expressed a preference for an independent FSLIC, but also recognizes the view of others that there are potential benefits in an administrative merger of the FSLIC into the FDIC.

To ensure political independence, the federal deposit insurer should continue to be funded by premium payments from insured financial institutions. Thus, the insurer should be independent from the Congressional appropriations process -- as the FDIC is now. While the insurer will be accountable to the Congress on an annual basis, it should remain free from annual budgetary controls since it receives no general tax revenues.

In this connection, we have recommended that the insurer's trust funds be separately budgeted and not be part of the general operational federal budget. For decades, the insurance funds have been depositing their unspent premium income into the U.S. Treasury. These "deposits" are counted as income to the Government rather than savings reserved for future problems in the industry. When funds are withdrawn from the Treasury to deal with a problem institution, that action is counted as a Government expenditure. Instead, it should be treated as a withdrawal of money on deposit.

In fact, the treatment of trust funds -- like the FDIC fund -- under the current federal budget system is affirmatively misleading. It provides misinformation about operational revenues and expenditures of the federal budget. Thus, we have suggested that the Congress consider setting up a separate budget for the deposit insurance funds. For macroeconomic purposes, however, analysts could combine the new deposit insurance separate budget with the general federal operating budget.

2. Enhanced Control Over Revenues

To ensure that the deposit insurer has adequate resources, it should have additional controls over its revenues. Most importantly, the deposit insurer must have the authority to adjust insurance premiums, within prescribed limits, to reflect experience and costs on a continuing basis. If the FDIC had such authority -- rather than being subject to the 1/12 of 1 percent assessment rate that has been in the law since 1935 -- 1989 premiums would be expected to increase significantly based on our 1988 loss experience.

Year-end results for 1988 indicate a net loss from operations of approximately $4 billion to the FDIC insurance fund. That means that the fund dropped from $18.3 billion to about $14 billion last year. Furthermore, the FDIC's fund dropped from 1.1 percent of insured deposits to a little over .8 percent of insured deposits during that one-year period. This demonstrates the need for a premium structure that can respond to the current environment and that has sufficient flexibility to maintain an acceptable level of reserves.

Other powers are necessary to enhanced revenue control. Borrowings that are secured by assets -- assets which otherwise would be available to the insurer in the event of a bank failure -- should be part of the assessment base. The insurer also should be able to require new institutions obtaining federal insurance to pay an entrance fee in order to maintain an adequate reserve-to-deposits ratio. Finally, the FDIC should be specifically authorized to borrow from both the Department of the Treasury and the Federal Reserve.

3. Improved Ability to Control Costs

The federal deposit insurer also must have additional tools necessary to control costs. In many respects, these mirror those that are available to private insurers. The fundamental tool is the ability to control the granting and revocation of insurance. At a minimum, the insurer should be able to set standards for insurability which must be certified by the primary federal supervisor as having been met. The insurer also must have the ability to promptly terminate insurance privileges when an institution is operating in an unsafe and unsound manner. The current procedures for terminating federal deposit insurance should be streamlined to take no more than six months from the start of a proceeding to removal.

The insurer also needs tools to determine whether an institution is posing an inordinate risk to the fund and to require the cessation of any activities that pose such risk. Thus, the insurer must be able to examine all insured institutions. Furthermore, it must have the express authority to determine that certain activities -- including more speculative activities authorized by states for state-chartered institutions -- pose an undue risk to the insurance fund and to require that institutions cease those activities within the insured institution itself. The insurer should be able to require that any such activity be conducted outside of the insured entity, in an affiliate or subsidiary, subject to "firewalls" designed to minimize the exposure of the insured entity to the activity that is being conducted in the separate, but affiliated, corporate entity. Those firewalls should include: (1) a prohibition against the use of the insured entity's regulatory-required capital to capitalize the subsidiary or affiliate; (2) assurances that transactions between the insured entity and its subsidiary or affiliate are on an arm's length basis and do not jeopardize the insured institution; and (3) a requirement that the institution divest the subsidiary or affiliate if the insurer determines that those requirements are not being met or that the affiliated entity poses a threat to the safety and soundness of the insured institution.

Additional tools also are necessary to enable the insurer to better control costs when dealing with failed institutions. It must have the power to require that all federally insured institutions owned by a common parent indemnify the insurer against any losses resulting from the failure of an affiliated insured institution. The FDIC believes this is preferable to the proposal circulated last year that would have required the consolidation of affiliated insured institutions within a holding company complex. Indemnification for such losses is a more direct and efficient way of accomplishing the same objective.

In resolving failures, the FDIC also should have the ability to distinguish between depositors and other claimants. Specifically, depositor claims should be able to be transferred to another institution while other claimants share on a pro-rata basis with the FDIC in asset liquidations.

All of the federal regulatory agencies also need enhanced enforcement authorities. The FDIC recommends that any legislative package adopted by this Committee include enforcement authorities and penalties substantially similar to those in the enforcement title from S. 1886, as passed by the Senate last year, and from H.R. 5094 as adopted by the House Banking Committee. These measures initially were submitted to the Congress jointly by all the federal regulatory agencies.

PRESIDENT'S PROPOSED LEGISLATION

President Bush recently proposed legislation entitled The Financial Institutions Reform, Recovery and Enforcement Act of 1989. That legislation was introduced last week, by request, as S. 413. It provides for funding the resolution of insolvent S&Ls and extensive structural and regulatory changes to the deposit insurance and thrift regulatory systems. Our comments on the size of the problem and its proposed funding are contained later in this testimony.

The FDIC supports S. 413 as a sound and viable measure that should be enacted promptly by the Congress. As noted, however, we have some points of disagreement with the legislation, each of which bears upon the independence of the FDIC. While those points will be addressed in detail below, in short, they involve (1) appointment of the FDIC Chairman; (2) restrictive limitations on the issuance of debt; and (3) reporting requirements.

As might be suspected, the President's proposal is not perfect from the FDIC's perspective. Clearly, some compromises had to be made along the way. We recognize that compromise is part of the process and none, in our view, compromises the essential soundness of the proposal.

For example, in the area of increased insurance authorities over the banking industry, the FDIC has been given substantially greater authority with respect to thrifts previously insured by the FSLIC than it has, or will have under the proposal, with respect to banks. Another example — state-chartered thrift supervision could have followed the pattern of state-chartered banks and thus be placed under the primary federal supervision of the FDIC. But they are not. We believe the legislation has reached workable solutions in each of these cases.

While we know this Committee is acutely aware of the need for expeditious legislative action to resolve the FSLIC situation, we would be remiss if we did not stress that point. Nothing of major substance can be accomplished until the Congress acts to provide funding and guidance.

Now we would like to turn to more specific comments on the President's legislative proposals for structural and regulatory reform. In its most fundamental components, the package incorporates most of the recommendations made in the FDIC study. It specifically provides for (1) the independence of the thrift insurer subject to the problems noted; (2) enhanced deposit insurance revenues and better control by the insurer over those revenues; and (3) additional tools to better control the insurer's costs.

1. Independence of the Insurer

The President's proposal would separate the FSLIC from the FHLBB and consolidate the FSLIC with the FDIC for insurance and case resolution purposes. While providing a single management and administrative structure, it would maintain the FDIC and FSLIC funds as separate insurance pools that could not be commingled. Each pool would have its own premium income stream and the expenses and expenditures of their respective institutions would be charged against their respective pools.

In separating the FSLIC from the Bank Board, the proposal also establishes a new structure for the chartering of federal thrifts and the supervision of all federal and state-chartered thrifts and their holding companies. The Federal Home Loan Bank Board would be dissolved and replaced by a single Chairman of the Federal Home Loan Bank System ("FHLBS") who would be under the Secretary of the Treasury -- just as is now the case for the Comptroller of the Currency ("OCC").

Making the thrift insurer independent is an essential step in ensuring that a situation like the one we are facing today does not recur. As stated earlier, from an agency point of view, the FDIC would have preferred to see the FSLIC separate from the FDIC. The judgement of the Administration has been that in terms of start-up time and costs, administratively merging the FSLIC into an existing insurance structure at the FDIC is more cost-effective. We will work diligently to ensure that result.

The President's plan does not provide for a separate budget — as recommended by our study — for the FDIC insurance funds.

Although the President's proposed legislation would make important progress in ensuring the independence of the former FSLIC, certain provisions of the plan run counter to the principle of establishing an independent deposit insurer. In fact, in each of these instances, the legislation would make changes to the existing independence of the FDIC that would limit its independence.

First, the bill would permit the President to appoint and remove, with or without cause, the Chairman and Vice Chairman of the reconstituted FDIC Board of Directors. At present, the Board of the FDIC elects its Chairman. We believe such removal authority could compromise significantly the independence of the FDIC, and recommend that it be deleted. In fact, when that removal authority is coupled with the fact that two of the other Board members are under Treasury, the FDIC Board, in effect, could be controlled by the Administration. If a change is needed, we would suggest that a system similar to the Federal Reserve System — appointment for a term with the consent of the Senate — be adopted.

Second, another provision of S. 413 would place limits on the FDIC's borrowing authority. We believe it is appropriate to limit the FDIC's ability to issue notes and other debt obligations. However, the proposed limitations are impractical and overly restrictive and could seriously undermine the safe and cost-effective operations of the insurer in the near term.

To put the proposed limit in perspective, it would restrict the FDIC's obligations to $7 billion. We are almost at the proposed cap already. Currently the FDIC has about $6 billion in obligations. In each case the liability was properly recorded with the appropriate charge taken against net worth.

The FDIC's $14 billion of net worth represents the unencumbered assets available in excess of that needed to satisfy all actual and contingent liabilities. In other words, the FDIC has not used debt because it does not have the necessary resources, but because of other valid business reasons. Examples of such reasons include providing failed bank acquirors additional

flexibility in markets with weak loan demand, avoiding untimely portfolio sales and even maintaining some additional leverage to ensure buyers hold up their end of the bargain. We would hate to lose this flexibility.

Thus, instead, we recommend a very simple borrowing limit: No notes can be issued which will put the agency into a deficit net worth position. Thus, the FDIC would be able to obligate neither itself nor the general government revenues in an amount beyond the limits of the FDIC's resources as determined by GAO audit. By imposing the limit that we recommend, the insurer could not issue debt if it does not have its own resources to repay that debt and, thus, could not obligate taxpayer funds.

Third, S. 413 would require the FDIC to submit quarterly reports to both the Secretary of the Treasury and the Director of the Office of Management and Budget on the FDIC's "financial operating plans and forecasts . . . taking into account the Corporation's financial commitments, guarantees and other contingent liabilities." We believe it should be sufficient to file such reports with the Administration through the Treasury and, to save costs and paperwork, the documents should be the financial reports prepared by the FDIC in the ordinary course of its business.

2. Enhanced Revenue Provisions

The President's legislative package establishes a new insurance premium structure that appears viable for both the FDIC and FSLIC insurance fund pools to be designated for the present, respectively, as the Bank Insurance Fund ("BIF") and the Savings Association Insurance Fund ("SAIF"). The insurance premium paid by banks into BIF would increase to 12 basis points in 1990 and to 15 basis points in 1991. Premiums on institutions in SAIF would remain at 20.8 basis points through 1990, increasing to 23 basis points for 1991 through 1993 and then dropping to 18 in 1994.

Furthermore, the FDIC would be provided with flexibility to raise the premiums above these levels if extraordinary circumstances raised the specter of serious future losses to the fund. On the other hand, once the funds of either BIF or SAIF exceed the target reserve level of 1.25 percent, then assessments could be rebated to the institutions insured by that particular fund.

The FDIC study recommended that premium rates be increased to more accurately reflect loss experience. S. 413 calls for such an increase and we support it. As discussed in more detail later in our testimony, raising bank premiums from eight basis points to 12, and then 15, seems reasonable and prudent and very close to the result under the recommendations contained in our study. Furthermore, as the FDIC requested, S. 413 would provide the insurer with flexibility to increase rates under specified circumstances.

The FDIC also believes the premiums charged to FSLIC insured institutions -- which rise to 23 basis points for a three-year period and then decline to a point lower than current premiums -- are both reasonable and apparently within the capacity of those institutions to pay. However, those increased premiums cannot be evaluated in a vacuum. There should be careful consideration of the effect on the industry's viability of these premiums coupled with the significantly increased capital requirements and loss of income from the FHLB System.

As we have consistently stated, the cost of resolving the savings and loan situation should be borne to the greatest extent possible by that industry. Just as importantly, the banks should not be called upon to bear the cost of that resolution. Appropriately, under the President's proposal, the revenues generated from bank premiums will go to build BIF and not to pay for the thrift problem.

Finally, the FDIC would be permitted, within its discretion, to charge a fee for institutions moving from one fund to the other. In its study, the FDIC recommended that fees be permitted in order to maintain a specified reserves-to-deposits level in the insurance fund.

3. Improved Provisions to Control Costs

The President's proposal provides for improved provisions to control insurance costs. As discussed above, the FDIC's study suggests numerous changes that should be made to the deposit insurance system to enable the insurer to better control costs. A primary cost control mechanism is to permit the insurer to operate more like a private insurer -- with control over the granting and revocation of insurance. The insurer also must be able to examine insured institutions to assess risk to the fund. The insured institution itself must be subject to adequate standards -- such as capital, accounting and disclosure -- and the insurer must have sufficient authority to enforce those standards.

An additional dimension to controlling insurance costs is requiring increased capital. In addition, when the insurer's resources have to be used to resolve a troubled institution, there are measures that can be taken to minimize the cost to the fund. Finally, stronger enforcement provisions assist the insurer in controlling costs.

The proposed legislation contains important new cost control tools in each of these areas. In fact, S. 413 goes a long way in providing the FDIC with the necessary tools to allow it to better control costs.

Enhanced Ability to Control the Granting and Revocation of Insurance. The President's proposal provides enhanced ability to control fund membership. Under S. 413, the FDIC would be able to deny insurance coverage to any S&L, both state and federal. As is the case currently with state-chartered banks, state-chartered thrifts would be required to apply directly to the FDIC for insurance. However, the FDIC also would be authorized to review and to deny any application for a federal savings and loan charter that would result in eligibility for insurance if the FDIC determines that specified statutory standards have not been met.

While under S. 413 insurance for national and state Fed member banks will continue to be automatic, the OCC and the Federal Reserve Board ("FRB") would be required to consider a new and additional standard -- risk to the deposit insurance fund -- before granting a national bank charter or Federal Reserve membership.

The FDIC would be provided with the authority to immediately suspend deposit insurance if an insured institution has no tangible shareholders' equity. Also, the FDIC would be able to promptly remove insurance from any insured

institution that is engaging in unsafe or unsound practices, operating in an unsafe or unsound condition or otherwise causing undue risk to the insurance fund. Under current statutory procedures, termination proceedings can take anywhere from two-to-three years to complete. An expedited hearing procedure would be established under the proposed legislation that would permit revocation within approximately six months of the filing of a notice of intent to terminate.

Improved Ability to Assess Risk. Under the President's proposed legislation, the FDIC would be provided with the necessary tools to examine and assess risk in thrifts. The FDIC would be entitled to copies of all examination reports filed with the FHLBS and would have the right, upon notification to the FHLBS, to examine all insured thrifts for insurance purposes.

This examination authority is the same as the FDIC's current authority with regard to national banks and state member banks. However, since in the past there have been some questions about the FDIC's authority to examine independently such banks to protect the insurance fund, the FDIC would like to have legislative history making this clear.

In addition to its new examination authority over thrifts, the FDIC would be authorized to request that the FHLBS or a state supervisory authority take any enforcement action applicable to any insured institution or its officers and directors. If the appropriate authority declines to take such enforcement action, the FDIC would be permitted to initiate that action independently. We believe this additional authority will be very helpful.

Improved Regulatory Standards Applicable to Thrift Institutions. The Bush legislative proposal appropriately applies bank-like regulatory standards to thrift institutions. It also provides additional powers to ensure safe and sound operations.

Under the proposal, the FHLBS would be required to establish capital standards for thrift institutions that are no less stringent than those for national banks. The standards would be required to be fully implemented by June 1, 1991 -- although thrifts would have ten years within which to amortize their goodwill. Thrifts also would be required to conform to accounting and disclosure standards now applicable to banks and the FHLBS would have to adopt supervisory policies equal to those now applied to banks.

We support high and consistent capital standards for S&Ls and banks. We must be sure, however, that the S&L industry can satisfy the bill's requirements within the time permitted without unduly damaging the viability of the weaker segment of the industry. Since this is a complex determination, appropriate flexibility should be provided the insurer so that the proper time-frame and balance can be assured.

The FDIC would have additional risk-reduction authorities under S. 413 relative to thrifts that it does not now have explicitly -- and would not be given under S. 413 -- with respect to banks. Specifically, the FDIC would be able to prohibit or restrict the growth of assets by a thrift institution that does not meet minimum capital standards established by the FDIC. We believe that the authority provided in S. 413 for the FDIC to establish such minimum capital standards is particularly important.

Furthermore, the FDIC would have the explicit authority to determine that state-authorized activities that are not permissible for federally chartered S&Ls pose an undue risk to the insurance fund and to require that the thrift cease conducting those activities within the insured entity itself. The FDIC believes that this last authority also is very important. We suggest that such activities be allowed in subsidiaries or affiliates of holding companies with appropriate safeguards through tough firewalls.

Improved Ability to Buy Thrifts. S. 413 takes steps toward expanding the pool of private capital that would be available to rescue the thrift industry. First, additional nonbank holding companies may be interested in acquiring thrifts once the cross-marketing and tandem operation restrictions of the Competitive Equality Banking Act ("CEBA") are lifted. Second, two years after enactment, bank holding companies would be permitted to acquire healthy thrift institutions, without the imposition of the tandem operation restrictions now imposed by the FRB.

While these two steps are helpful, the FDIC believes that bank holding companies should be permitted to acquire failed or failing S&Ls immediately, without the cross-marketing, activity and branching restrictions or any other restrictions that have been routinely imposed by the FRB. To date, when bank holding companies are permitted to acquire failed or failing thrifts, the Federal Reserve prohibits them from changing the thrifts name in any way that would lead thrift customers to believe that the institution is a commercial bank. However, the FRB then also requires the thrift to operate as if it is a bank, subject to bank branching and activity limitations. The FDIC thinks that the imposition of cross-marketing, activity and branching limitations on the acquisition of failing and failed thrifts by bank holding companies unwisely curtails the ability of banks to buy thrifts and, thus, raises the insurers' costs.

Sound Protection for the Insurance Fund in Handling Failed Banks. S. 413 contains the fund indemnification provision that the FDIC believes is vitally important in dealing with failed insured depository institutions that are commonly controlled. The legislation would require that all such institutions that are under common control guarantee the insurer against loss in the event of a failure of any of the other insured institutions so commonly controlled.

The proposed legislation also includes another very important measure that would help the FDIC to minimize the funds' exposure in failed bank resolution cases. That provision would allow the FDIC to distinguish between depositors and other claimants in resolving failures. Specifically, depositors claims could be transferred to another institution while other claimants would share on a pro-rata basis with the FDIC upon liquidation of the failed institution's assets. It is important to point out that this is not the "depositor preference" measure that the FDIC recommended during the 99th Congress. Under depositor preference statutes, other claimants are subordinated to the FDIC. Under this proposal, other claimants would share pro-rata with the FDIC.

Enhanced Enforcement. S. 413 also would include enhanced enforcement provisions very similar to those included in the bill that was adopted by the Senate and the House Banking Committee in the last Congress. These measures originally were proposed jointly to the Congress by all of the federal financial regulatory agencies. We believe that those measures, as well as the

enhanced civil and criminal penalties contained in the President's bill, are important to the agencies' ability to deal with mismanagement, waste, fraud and insider abuse. We question, however, whether the amount of some of the new civil penalties are not too Draconian.

BUDGETARY IMPACT OF PROBLEM

We now will turn to two of the other issues raised in the Committee's letter of invitation — the size of the S&L problem and the proposal for financing that problem.

Size of the problem. In order to estimate fully the budgetary implications of the thrift problem, ascertaining the size of the insurance loss is critical. At the beginning of 1988, there were approximately 500 insolvent thrifts under generally accepted accounting principles ("GAAP") with assets over $200 billion. During 1988, the Federal Home Loan Bank Board ("FHLBB") took action on more than 200 S&Ls at a reported cost of over $39 billion on a present value basis. We understand that the General Accounting Office ("GAO") soon will release a cost analysis of S&L transactions during 1988.

As of the end of the third quarter of 1988, there were about 220 thrifts that were insolvent under regulatory accounting principles ("RAP"), not including those thrifts handled by the FHLBB in 1988, and another 119 GAAP insolvent thrifts. In addition, there would be approximately another 100 insolvent S&Ls under banking standards — namely, if goodwill were eliminated. Our latest estimates suggest that current operating losses at RAP and GAAP insolvent S&Ls

are about $200 million per month. That figure will be higher as interest rates rise or as S&Ls experience unusual deposit outflows, as they have recently, and must fund with higher cost deposits.

We have stated in the past that reliable cost estimates of resolving the insolvent S&Ls should be made by on-site examinations. We are in the process of making such estimates pursuant to the joint oversight effort discussed below. Our best estimates at this time are in the same range as the Treasury Department's estimated cost. See the attached Charts A and B.

When discussing cost figures, it is important not to confuse present value with actual dollars spent over the life of the workout. Charts A and B provide information on those cost figures. The present value is the appropriate figure to focus on -- it represents the cost in today's dollars. The actual dollar figure mixes apples and oranges because a dollar spent in the future is worth less than a dollar today.

For example, consider buying a house that sells for $100,000. One could either pay cash or finance it. If the purchase is financed with, say, a 30-year fixed rate mortgage at 10 percent annual rate, the monthly payment will be approximately $875. Over the thirty years, the payments add up to $316,000. Even though the person who finances the house outlays, over the life of the mortgage, more than three times the number of dollars than the person who pays cash, we do not say that the house costs three time as much for people who finance.

The cost estimate which is projected by the President's proposal is based on today's dollars. If the rescue plan is financed, the actual dollars outlayed will be substantially higher than that amount, but the cost will not be.

Bush Reform Plan financing proposal. Regarding the financing package, the Treasury Department and the OMB are in the best position to comment. From our viewpoint, the President's proposal, while complex, appears viable and sound. The proposal provides for what appears to be an equitable sharing of the financial burden between the S&L industry and the Treasury. However, the plan should assure that ultimately the SAIF be an independent, self-funded insurance fund. The attached Chart C provides a pictorial of the sources and uses of funds under the proposed financing plan.

Ability of banks and S&Ls to pay increased premiums. The legislative proposal calls for increased insurance premiums for both banks and S&Ls. The increased premiums for the S&Ls will be used to partially offset the cost of that industry's problems. The banks' increased premiums will be used to strengthen the FDIC insurance fund. Both premium increases will add to general federal revenues for budgetary purposes.

In our recently released study on deposit insurance, we concluded that FDIC deposit insurance premiums should be adjusted for the risk and costs incurred by the insurance fund. The FDIC spent $7 billion dollars last year, and our fund declined by about $4 billion, or over 20 percent. Our fund's reserves at year-end will be reduced to 83 cents per $100 of insured deposits, well below desired levels. Without regard to the S&L industry problems, the FDIC study recommended that bank premium rates be increased to reflect more accurately recent loss experience of the FDIC fund.

S. 413 calls for such an increase -- and we support this proposal. Raising bank premiums from their current level of 8.33 basis points to 12 basis points next year, and then 15 basis points the year after, is reasonable. We estimate going to 12 basis points will increase premiums about $700 million, and that 15 basis point will bring in almost $600 million more.

The increase in premium expenses translates to about 2.1 percent and 3.8 percent of pre-tax earnings at 12 and 15 basis points, respectively. To some extent, this increase probably could be offset by repricing of services, but the ability to do this is constrained by today's competitive market place. Assuming that all the increase resulted in earnings reductions, we estimate that fewer than 100 institutions out of over 13,000 that are now profitable would be made unprofitable.

The majority of the banks that would suffer the most significant decline in profitability from higher assessments are located in the Southwest and Midwest regions, the two regions that have experienced the greatest difficulties during this decade.

Given recent FDIC loss experience, the increases are consistent with our study's conclusions and should not pose an unreasonable burden to the banking system. Importantly, the revenues generated from these premiums will go solely to build the new BIF — the fund that insures banks.

Under the proposed legislation, once BIF moves up from .8 to 1.25 percent of insured deposits, banks can expect premium rebates. Our preliminary estimate is that rebates could begin as early as the mid-1990s under the President's plan.

We recently completed an evaluation of the rebates the FDIC paid from 1950 through the early eighties. We added all rebates from that period back into our fund and applied the yield we would have earned on those funds. We discovered that, if no rebates had been paid during that time, the FDIC today would have another $26 billion in its insurance fund.

This indicates that the current rate of eight basis points was more than sufficient to meet costs if no rebates had been paid. Thus, a return to lower premiums may be indicated at some future date.

As to the increase in premiums on S&Ls, in and of itself, it will not unduly damage the industry. As previously stated, flexibility should be provided the insurer so that it can act if industry viability is threatened.

INTERAGENCY OVERSIGHT EFFORT

I would now like to turn to the interagency oversight effort underway to deal with the currently RAP insolvent S&Ls.

As part of the Bush Reform Plan, the President recently requested that the FDIC lead a joint effort to evaluate and oversee most of the RAP insolvent thrifts. In addition to the FDIC and the FSLIC, the Federal Home Loan Bank Board, the Federal Reserve, and the Office of the Comptroller of the Currency are participating in this interagency initiative.

The purpose of this interagency effort is to limit the growth of problems in our nation's insolvent thrifts until a comprehensive reform of the deposit insurance system and the necessary funding are authorized by the Congress. Insured deposits will remain fully protected throughout this process.

Since the program was announced by President Bush on February 6th, a joint task force of regulators, led by the FDIC, has taken control of 36 of the RAP insolvent thrifts. We plan to go into another 38 this week and expect to assume oversight of the rest of the over 200 RAP insolvent thrifts in the next four-to-six weeks.

The FSLIC has contracted with the FDIC to take control of these institutions that are being placed in conservatorship or receivership. That means the FDIC, with the help of other regulators, will oversee operations of the insolvent thrifts. Managements of the various institutions are subject to the regulators' authority. From the customer's perspective, however, the only visible difference will be a few more people in each institution. Day-to-day operations will continue to preserve basic services to deposit and loan customers.

One of the first priorities of these oversight efforts will be to evaluate the losses at each S&L. Such on-site examinations are necessary to produce accurate estimates of the cost of the thrift problem. Once our estimates are completed and GAO has issued its report on the cost of FSLIC's 1988 deals, the total cost of this problem can be determined.

Another top priority is to identify and stop any abuse, waste, or fraud that may be present. A further priority will be to prepare a business plan for the institution and seek cost reduction through consolidations and more efficient operations.

While in control of these institutions, we and the other regulators will seek to stop any unsafe or unsound practices. We will limit their growth, and downsize them through asset liquidations where possible. However, we will avoid firesales of assets and emphasize the need to sell at values that reflect current appraised values.

Finally, we will develop longer-term solutions to these problems. Our staff will recommend different approaches -- from liquidating the institutions to selling them to qualified purchasers. But our current job is a holding action only. We will not issue notes or enter into income maintenance agreements.

The FDIC has established four task groups to address these responsibilities. These task groups are designed to ensure stable operations in the insolvent thrifts and to evaluate options for permanently resolving their insolvency once funding is approved by Congress.

One of our most important task groups is our new Fraud Squad. As President Bush has said, "unconscionable risk-taking, fraud and outright criminality have also been factors [in the thrift problem]." Investigators assigned to this Fraud Squad will constitute a mobile unit. Whenever our on-site teams discover evidence that fraud or insider abuse may have occurred, the Squad will be sent to conduct a full-scale investigation. This includes looking for ways to get back misappropriated assets when possible, and helping send some to jail when appropriate.

Our three other task groups have separate but complementary assignments.

Our Oversight and Evaluation task group will take control of these institutions, assess their condition and take steps to reduce operating costs where possible.

Our Planning and Restructuring task group will recommend steps to restructure and consolidate institutions where appropriate.

And our Transaction and Acquisition task group will begin the process of seeking out buyers for institutions, real estate and other assets. We will seek to reach agreements with purchasers subject to resources being made available to provide assistance.

The FDIC and the FHLBB have agreed that, until the agencies review the status of the insolvent thrift institutions placed under joint regulatory oversight, only cash assistance transactions will be undertaken by the FSLIC.

We also must note that these additional responsibilities in addressing the S&L situation will place some strain on FDIC resources. We believe that this will not substantially interfere with our responsibilities as a bank regulator. We are dedicated to this new task and will strive for success, but we do expect to experience growing pains and recognize our need to climb a learning curve in the process.

NEED FOR A SEPARATE THRIFT INDUSTRY

The Committee's letter of invitation also asked us to comment on the need for, and viability of, a separate regulated thrift industry. If we did not have a

separate thrift industry today, our reaction is that there would be a question as to whether we need a separate industry dedicated to financing housing. Today, there are many sources vying for that business.

However, we are not starting from scratch. We do have a separate thrift industry now that provides approximately 40 percent of this nation's housing funding. Although that percentage is declining, so long as the public is being provided with that volume of home financing, the industry fulfills an important public purpose.

We believe, however, that it is extremely important that, to the extent we maintain this specialized industry, those institutions must be required to dedicate themselves to that role. Unfortunately, the trend has been in the opposite direction. Thrift institutions now have much broader authorities than commercial banks in many respects and, thus, have forsaken the purpose for which they were chartered. Thus, if a separate thrift industry is to be maintained, it should be devoted primarily to the financing of housing and should not be permitted to engage in incompatible ventures. To assure viability in this era of volatile interest rates, the industry must be supervised to limit interest rate risk through appropriate flexible rate mortgages and securitization.

Ultimately the market will determine the long-range future of the industry.

CONCLUSION

With the exceptions noted, we believe the Bush Reform Plan is a sound, constructive and farsighted proposal, and hope Congress acts on it promptly.

We would be happy to work with the Committee on any aspect of the S&L situation where we may be helpful. I would be pleased, at this time, to answer any questions the Committee may have.

CHART A

3rd QUARTER SUMMARY SHEET DATA ON FINANCIAL TROUBLED S&Ls ($BILLIONS)

S&L Group	NO.	Total Assets	Total Liab.	Annual Income	Est. Cost #1	Cost To Assets	Est. Cost #2	Cost To Assets
Handled by FSLIC in 1988	208	$103.2	$120.1	$-10.2	$38.9	.38	$42.9	.42
Other:								
RAP - Insolvent & Unprofitable	217	$56.9	$65.6	$-5.3	$22.8	.40	$25.0	.44
RAP - Insolvent & Profitable	5	$2.5	$2.5	$0.0	$0.4	.16	0.6	.24
SUBTOTAL	430	$162.6	$188.2	$-15.5	$62.1	.38	$67.9	.42
RAP Solvent but GAAP -- insolvent & unprofitable	72	$24.2	$23.7	$-0.3	$3.6	.15	$4.8	.20
RAP - Solvent but GAAP - insolvent & profitable	45	$12.1	$11.7	$0.3	$1.6	.13	$2.2	.18
SUBTOTAL	547	$198.9	$223.6	$-15.5	$67.3	.34	$74.9	.38
RAP & GAAP - solvent but tangible insolvent and unprofitable	69	$55.1	$53.2	$-0.5	$8.3	.15	$10.9	.20
RAP & GAAP solvent but tangible - insolvent and profitable	52	$66.4	$63.5	$0.2	$6.8	.10	$10.9	.16
SUBTOTAL	668	320.4	$340.3	$-15.8	$82.4	.26	$96.7	.30
Marginally solvent but unprofitable	154	$101.1	97.6	$-0.7	$9.6	.09	$14.9	.15
TOTAL	882	$421.5	$437.9	$-16.5	$92.00	.22	$111.6	.26

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[1] Estimated Cost #1 :Failed-bank cost formula with zero loss assigned to residential mortgages and pass-through securities.

[2] Estimated Cost #2 :Failed -bank cost formula with 10% loss assigned to residential mortgages and mortgage pass-through securities.

CHART B

ADMINISTRATION'S FINANCING PROPOSAL*
(in billions of dollars)

		Time to Maturity		
		10 years	20 years	30 years
Interest Rate	2%	100-125	115-140	125-150
	4%	115-140	135-165	160-200
	6%	125-160	160-200	200-250
	8%	140-170	190-230	250-300
	10%	150-180	215-265	300-350

*Cash flows represent actual dollars spent if net present value cost of $90-110 billion is financed over different time periods at interest rates shown in chart.

CHART C

ADMINISTRATION'S FINANCING PROPOSAL

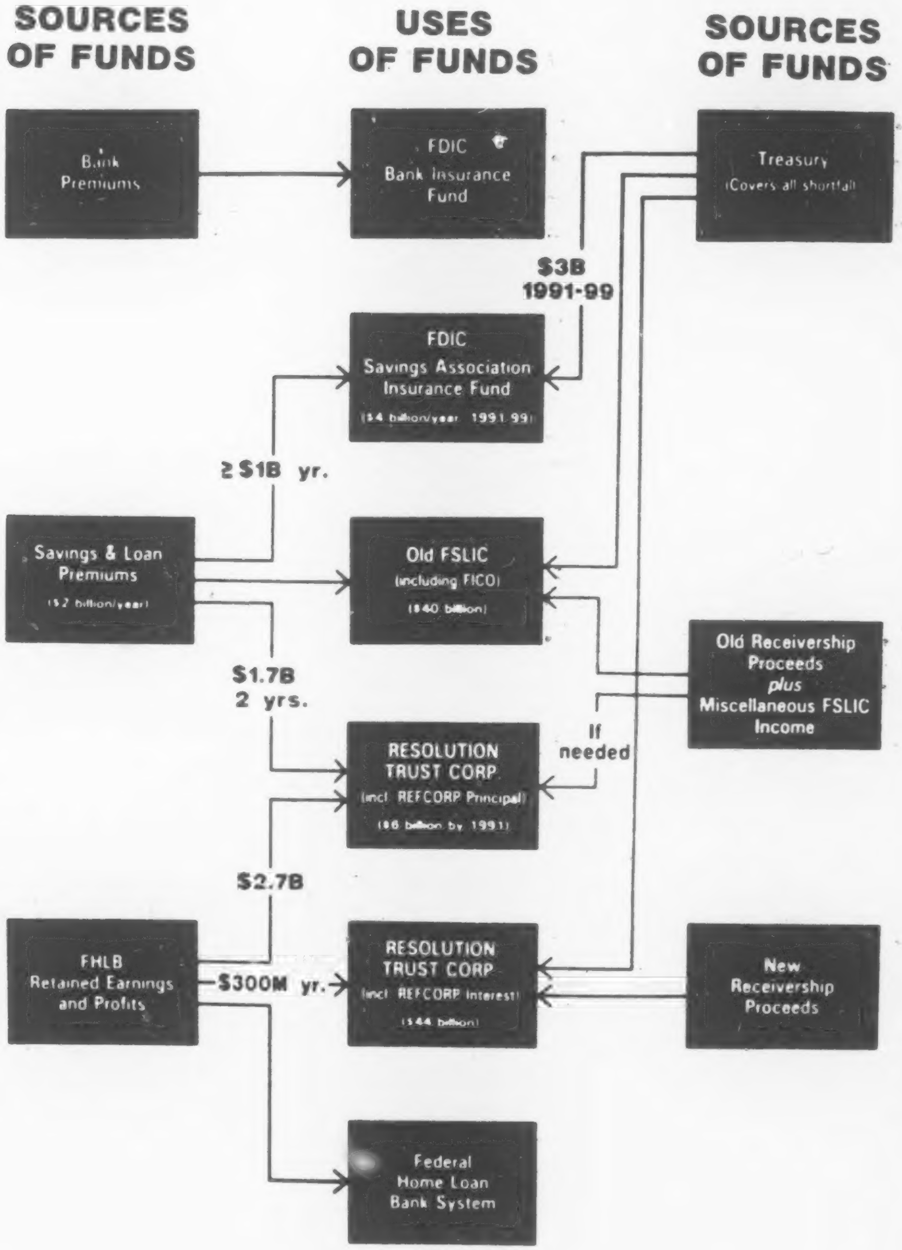
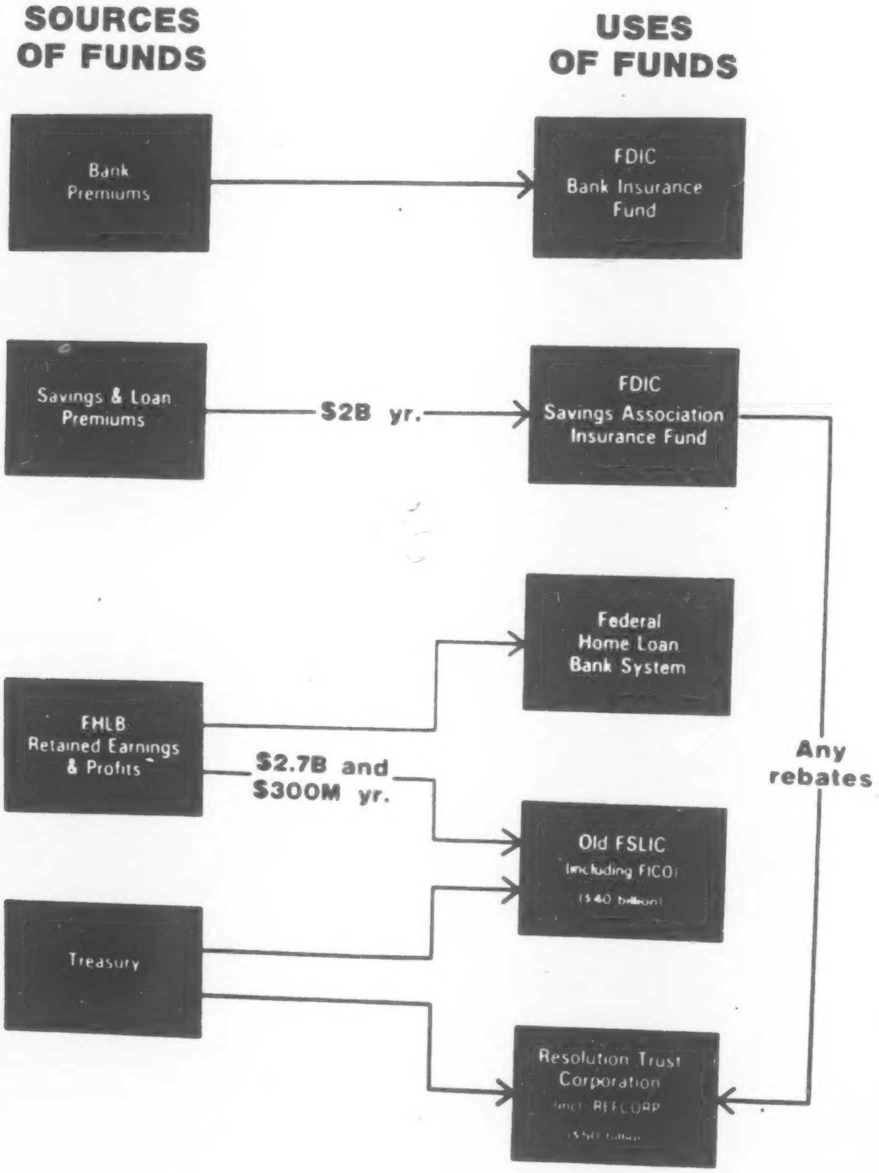

SOURCES OF FUNDS
USES OF FUNDS
SOURCES OF FUNDS
Bank Premiums
FDIC Bank Insurance Fund
Treasury (Covers all shortfall)
$3B 1991-99
FDIC Savings Association Insurance Fund ($4 billion/year 1991-99)
≥ $1B yr.
Savings & Loan Premiums ($2 billion/year)
Old FSLIC (including FICO) ($40 billion)
Old Receivership Proceeds *plus* Miscellaneous FSLIC Income
$1.7B 2 yrs.
If needed
RESOLUTION TRUST CORP. (incl. REFCORP Principal) ($6 billion by 1991)
$2.7B
FHLB Retained Earnings and Profits
$300M yr.
RESOLUTION TRUST CORP. (incl. REFCORP Interest) ($44 billion)
New Receivership Proceeds
Federal Home Loan Bank System

CHART D

ALTERNATIVE FINANCING PROPOSAL


SOURCES OF FUNDS
USES OF FUNDS
Bank Premiums
FDIC Bank Insurance Fund
Savings & Loan Premiums
$2B yr.
FDIC Savings Association Insurance Fund
Federal Home Loan Bank System
FHLB Retained Earnings & Profits
$2.7B and $300M yr.
Any rebates
Old FSLIC (including FICO) ($40 billion)
Treasury
Resolution Trust Corporation (incl. REFCORP) ($50 billion)

EXECUTIVE SUMMARY

This report, "Deposit Insurance for the Nineties: Meeting the Challenge," is a review of the federal deposit insurance system. The FDIC undertook this review because of a growing realization that deposit insurance requires some fundamental changes if it is to continue to serve the purposes for which Congress created it over 55 years ago.

Virtually all agree that deposit insurance has accomplished its basic goals of maintaining stability and confidence in the banking system, and that these goals are vital to our Nation's economy. Deposit insurance has helped ensure a sound banking system by providing a safe haven for people's money, thereby instilling confidence and preventing panic-driven bank runs.

Our Nation must have a sound banking system because that system is at the very heart of our economy. Banks are essential to the payments mechanism, to the control of the money supply, and to the provision of financial intermediation--the bringing together of borrowers and savers.

Deposit insurance also has helped maintain a flexible and responsive banking system by facilitating a decentralized structure where new and smaller banks can compete against larger institutions.

While deposit insurance has provided many social and economic benefits, the events of the last decade have brought into clear focus that the current deposit insurance system has created potentially staggering costs.

Simply put, federal deposit insurance allows thousands of institutions to leverage their capital with government-backed funds--deposits. Imprudent decisions by only a relative handful of financial institutions can generate enormous losses for the deposit insurer. Strong supervision and market discipline are critical to keeping in check the risk-taking incentive created by this structure.

Deposit insurance should be self-funding--premiums collected and invested should be sufficient to cover costs of problems when they develop. The system worked well in the days of limited financial institution competition and relatively stable economies and interest rates--before technological revolutions and global competition required deregulation. Now, the business of deposit insurer is more complex and, often, more costly.

For 1988 alone the FDIC will show a 15 to 20 percent reduction in its fund--its first operating loss ever. While the FDIC expects to make an operating profit in 1989, changes are necessary to ensure sound future operations.

The potential costs of deposit insurance are even more obvious in our sister insurance agency, the Federal Savings and Loan Insurance Corporation

(FSLIC), where hundreds of thrifts are insolvent and even the most optimistic resolution costs greatly exceed the fund's and the thrift industry's resources.

Our Study looks at the FDIC's recent experience, and that of FSLIC, and explores how to improve deposit insurance so that it can be made a cost-effective system for the Nineties.

The FDIC Study concludes that the following principles are required to provide a sound deposit insurance system for the Nineties.

First, deposit insurers should be made as financially and organizationally independent as possible. The insurer must be sensitive to the concerns of chartering authorities and the industry it insures, but it must have the freedom to control costs. To ensure political independence, the insurer should be self-funded. It should have a budget separate from the general federal budget and the insurer should not be allowed to obligate federal revenues. The insurer also should be independent from the Congressional appropriations process. The insurer should remain accountable to Congress and the Administration, yet remain free from annual budgetary controls.

Second, the federal deposit insurer must be given certain basic tools that would be available to a private insurer to control costs. These include:

o The ability to promptly terminate insurance privileges when an institution is operating in an unsafe manner.

o The ability to set standards for insurability by a federal deposit insurance system.

o The authority to examine and assess risk at all insured institutions.

Third, to ensure adequate resources, the insurer should have additional controls over its revenues:

o The power to adjust insurance premiums, within prescribed limits, to reflect experience and costs on a continuing basis.

o The power to assess borrowings that are secured by assets--assets that otherwise would be available to the insurer in the event of failure.

o The power to require that institutions obtaining federal insurance pay an entrance fee sufficient to maintain the ratio between the insurance fund and insured deposits.

o The power to borrow from both the Department of the Treasury and the Federal Reserve.

o The power to require all federally insured institutions owned by a common parent to indemnify the insurer against any losses resulting from the failure of an affiliated bank. The FDIC prefers this option to an earlier proposal that would have required the consolidation of affiliated banks.

The Study also offers other recommendations: First, the FDIC seeks clear authority to distinguish between depositor and nondepositor claims in failure-resolution transactions. This approach differs from previous calls for depositor preference statutes in that nondeposit creditors would maintain their pro rata rights to the assets of the failed institution. Such creditors may have to wait along with the FDIC for assets to be liquidated, while depositor liabilities are transferred to another institution.

Second, the FDIC continues to advocate moving toward a system where nontraditional activities take place outside the bank in subsidiaries using excess bank capital or in separately capitalized affiliates. Under such conditions, the FDIC recommends that banking organizations be allowed to become involved in a wide variety of activities.

Third, the experience of the past several years demonstrates that regulatory agencies must work to improve their supervisory capabilities. Regulatory agencies must maintain highly skilled, professional staffs. In addition, regulators must improve their understanding of risk diversification and the competitive and economic environments in which their banks operate. New regulatory methods of anticipating potential problems are suggested. In this regard, the FDIC plans to work with other regulators, industry representatives and academics to develop regional oversight committees.

The Study reviewed other proposals for improvements to the system. A fundamental conclusion is that proposals to increase so-called depositor discipline by curtailing insurance protection should be rejected. The FDIC view is that increasing pressure on depositors to control bank risk in a

rational manner is impractical. Most depositors looking for safe, short-term investments cannot be expected to know the true condition of a financial institution. That is challenging enough for examiners and analysts who have regular access to bank management and records. Most importantly, attempts to increase depositor discipline would increase the threat of financial instability and bank runs, and undermine the very reason deposit insurance was deemed necessary.

The FDIC also rejects so-called "narrow-bank" proposals that would restrict depository institutions to only the most liquid and safe investments. Forcing lending operations out of banks, which would be required by these proposals, would be inefficient in view of banks' considerable expertise in financial intermediation. Further, in order to maintain stable economic growth, our government would need to develop other approaches to ensure that short-term, risk averse, investors can be brought together with borrowers with long-term and complex needs for funds.

While the FDIC rejects decreasing depositor protection, it cannot support proposals to increase depositor protection to 100 percent. FDIC experience and recent studies show that depositors remain fairly sensitive to bank risk-taking. To completely eliminate such constraints would increase the potential risk to the insurer.

Arguments to raise or lower deposit protection also stem from the perceived inequity in the way large banks are handled relative to small banks. The FDIC acknowledges that some inequity does exist. Uninsured depositors in very small banks sometimes bear somewhat greater risk of loss than those in large banks. Under current law, the FDIC must determine that protecting uninsured depositors is cost-effective in failure resolutions or that factors exist that make it essential to protect uninsured depositors.

Experience shows that protecting all depositors is more likely to be cost-effective in larger banks because of greater relative franchise value maintained in large banks.

The FDIC can deviate from the cost test on rare occasions when a bank is found to be essential to its community--but such essentiality considerations are more likely to exist with larger banks than smaller institutions. To address this inequity, the FDIC will continue its practice of trying to avoid depositor losses whenever possible. In recent years over 99 percent of all deposits in failed banks have received full protection.

The study concludes that, on balance, the current deposit insurance system provides an appropriate balance between depositor discipline and financial stability. Our view is that risk-taking incentives created by deposit insurance can be controlled through ensuring market discipline by investors and management, adequate capital requirements, improved regulatory structure, and strengthened supervisory process.

While studying deposit insurance, the FDIC reviewed the problems facing its sister insurance agency--the FSLIC. The most obvious problem is to provide funding so that hundreds of insolvent institutions can be resolved. It appears the federal government will have to absorb much of this cost, since the thrift industry is not strong enough to shoulder the burden alone.

Moreover, the FDIC finds no reason for the banks to be singled out to pay for the thrift industry's problems. The Study reviews proposals for ameliorating the impact on the federal deficit of the costs of returning FSLIC to solvency.

Equally as important as arranging for adequate funding is taking steps to ensure current losses do not recur. Many of the recommendations for deposit insurance reform discussed earlier are necessary for a viable and responsive insurance system. There are a variety of alternatives for implementing these reforms for FSLIC. The study recommends three possible options that satisfy the requirements set forth above. These options can be called: (A) A new stand-alone FSLIC; (B) An administrative merger of FSLIC into FDIC; and (C) Comprehensive reform of the thrift regulatory structure. (See attached Appendix A.) The FDIC favors option A.

A stand-alone FSLIC envisions the creation of a separate FSLIC that is independent of the Federal Home Loan Bank Board (FHLBB). The FHLBB would continue to charter and supervise federal thrift institutions and would operate both the Federal Home Loan Bank System and the Federal Home Loan Mortgage Corporation (Freddie Mac). The newly-separated FSLIC would directly supervise all state-chartered thrifts and be responsible for all liquidation activities related to FSLIC-insured institutions. The FSLIC would not be subject to the appropriations process. The district Federal Home Loan Banks would no longer examine or supervise thrifts. Their role would be confined to providing liquidity for institutions meeting housing-related criteria. System membership would be available to any depository institution meeting these criteria.

The second option is an administrative merger of FSLIC into FDIC. There would be common management and an administrative Board over separate FDIC and FSLIC funds. The new FDIC would supervise state-chartered thrifts and state-chartered banks that are not members of the Federal Reserve System and would perform all liquidation activities for insured banks and thrifts.

The third option calls for comprehensive reform of the deposit insurance regulatory structure. The administrative functions of the FSLIC and the FDIC would be merged into a new corporation. The Office of the Comptroller of the Currency (OCC) would assume responsibility for chartering and supervising federal thrifts, and the Federal Reserve Board would supervise thrift holding companies. The FHLBB would continue to oversee the Federal Home Loan Bank System and Freddie Mac, under the umbrella of the Department of Housing and Urban Development or the Federal Reserve Board.

These are the major conclusions and recommendations in our Study. A summary of the discussion in each chapter follows.

Introduction

Chapter 1 provides a brief introduction to the FDIC's examination of our federal deposit insurance system. Concerns about the continued viability of the deposit insurance system stem from the economic, technological and regulatory changes that have affected our economy's financial markets over the past decade. Deposit insurance reform was examined at length following the

financial deregulation of the early 1980s. In general, these studies found that the regulators' ability to control excessive risk-taking had been hampered by the changing financial environment.

Today, deposit insurance reform continues to receive attention. Proposals to modify the system range from a major scaling back of insurance guarantees and greater depositor discipline, to increased emphasis on capital requirements, supervision and timely closure of insolvent institutions. This Study examines the current system and recommends changes to enable the deposit insurance system to meet the challenges ahead.

Framework for Analyzing Deposit Insurance Reform

Chapter 2 reviews the benefits and costs associated with the provision of deposit insurance and provides a framework for analyzing deposit insurance reform. Deposit insurance promotes financial stability by preventing bank runs. However, deposit insurance also may create an incentive for banks to take excessive risks. (While the owners of insured deposits have little incentive to participate in bank runs, they also have little incentive to pay attention to the riskiness of their bank's activities.) These two fundamental effects of deposit insurance, and the relative importance one may attach to them, underlie all of the numerous proposals to replace, curtail, or otherwise reform deposit insurance.

Comprehensive deposit insurance reform tends to be favored by those who take the view that the benefits associated with the prevention of bank runs are less important than the costs associated with the risk-taking incentives created by deposit insurance; or that the costs associated with bank runs can be controlled adequately by alternatives to deposit insurance.

Proponents of more modest reform take the view that the more significant costs are associated with bank runs, and that risk-taking incentives created by deposit insurance can be controlled adequately through market mechanisms, capital requirements and the supervisory process. The FDIC's view falls into this category.

Deposit Insurance Pricing

In Chapter 3, "Deposit Insurance Pricing," problems associated with the current flat-rate pricing scheme and the feasibility of implementing a system of explicit risk-related premiums are addressed. In the absence of regulation and supervision, flat-rate premiums provide incentives for excessive risk-taking and inequitably distribute the burden of insurance losses among banks. If unchecked, these perverse incentives may lead to an excessively risky banking system and undermine the viability of the deposit insurance system.

In practice, this incentive toward excessive risk-taking is counterbalanced, to some extent, by existing market discipline and through regulation and supervision. Federal and state regulators periodically examine banks to determine if they are operating in an unsafe or unsound manner. Undesirable behavior is penalized through the issuance of cease-and-desist orders or the imposition of other sanctions. In addition, laws and regulations limit the kinds of activities that insured institutions may engage in and set minimum capital requirements. To the extent that these implicit costs vary with the riskiness of the bank, they function as a system of risk-related premiums and constrain risk-taking.

The major question is whether an explicit risk-related pricing formula could be established that would be an improvement over the current system of flat-rate premiums, regulations and supervisory sanctions. In assessing this question, a number of risk-related pricing schemes are reviewed. Risk-related schemes that rely on market information to assess bank risk generally suffer from problems in obtaining accurate market information for all insured institutions. In the absence of a market-based approach, the FDIC would be left with the task of administratively determining an explicit pricing formula. Thus far, it has not been possible to establish a satisfactory pricing formula based on ex ante or before-the-fact measures of risk.

It does appear feasible to establish a general pricing formula that would complement the existing supervisory sanctions, based on ex post or after-the-fact measures of risk. The adoption of such a system, with only modest premium differentials at first, will not eliminate entirely the incentive for banks to take excessive risks. However, it may offer somewhat greater deterrence, require regulators to assess risks more diligently, and allocate the costs of insurance more equitably among banks.

While a more equitable distribution of the insurance burden is desirable, an even more critical concern is to ensure adequate funding for the insurance agency. An adequately financed deposit insurance system is important for three reasons. First, an insolvent insurer has similar incentives to take excessive risks as does the management of an insolvent insured depository; this helps explain actions of FSLIC in the early 1980s in encouraging thrifts to grow out of their problems by further leveraging nonexistent capital. Second, the passing of expenses and losses to the industry on a more current basis will provide greater incentives for the development of self-regulation and mutual risk-reduction measures. Finally, Congress and the public have every right to have assurances that the need for taxpayer money in the future will be minimal.

To help ensure adequate funding for the insurer over the long run, several recommendations are presented in Chapter 8. First, total assessments to the industry should be based on a modified three-year average of actual loss and expense accruals. Limits may be appropriate for year-to-year changes in assessments and for the maximum level of assessments.

Second, the assessment base should be expanded to include secured borrowings. While there are good arguments for also including foreign deposits in the assessment base, there is sufficient uncertainty with respect to certain issues that no recommendation is made at this time.

Third, the rebate system should be based solely on the relationship of the fund to the assessment base. Rebates would begin when the ratio of the fund to the assessment base exceeded a threshold level.

Fourth, the FDIC should be given direct authority to borrow from both the Department of the Treasury and the Federal Reserve System.

Finally, operating institutions obtaining FDIC insurance should pay an entrance fee sufficient to maintain the ratio of the fund to the assessment base at a constant level. This could be accomplished through a one-time charge or a deposit that is taken into the fund over time.

Market Mechanisms for Controlling Risk

Chapter 4, "Market Mechanisms for Controlling Risk," examines market discipline as a form of risk control in banking. Market mechanisms for controlling risk are considered under four broad categories: insurance coverage (depositor discipline), disclosure, capital standards, and the priority of claims in bank liquidation (depositor preference and nondepositor discipline).

Based on the premise that de facto 100 percent coverage has rendered depositor discipline ineffective, some have argued for explicit, 100 percent coverage of deposits, regardless of size. Full coverage, it is argued, could result in greater stability with respect to bank runs, more equity in the system, and also could allow for a more consistent and orderly resolution of bank failures. Moreover, 100 percent coverage may facilitate certain changes in failure-resolution methods that, according to proponents, would increase the effective level of market discipline. The major problem with this argument is the assumption that depositor discipline is completely absent from the current environment. FDIC experience suggests otherwise and recent studies also contradict this, suggesting that CD markets are fairly sensitive to bank-specific risk and act to constrain banks wishing to pursue riskier activities.

Others have argued that there should be greater depositor discipline; that deposit insurance coverage levels perhaps should be reduced from the present $100,000 level; and that in order to control bank risk-taking, uninsured deposits should be exposed to losses in bank failures. However, the problem with depositor discipline is the same one that existed in the 1930s, which led to the creation of the federal deposit insurance system: depositor discipline can lead to destabilizing bank runs.

What proponents of greater depositor discipline often overlook is that market discipline presently exists in many important respects. Bank stockholders, bank management and bank holding company creditors almost always suffer losses when a bank fails. Each of these groups has an incentive to control a bank's risk-taking. Uninsured depositors and creditors also exert some control over bank risk-taking, since they are not assured of complete protection in a bank failure.

Chapter 4 concludes that existing levels of market discipline appear adequate to control risk-taking by healthy banks. The Study recommends against any change to the $100,000 limit for individual deposit accounts. Limits to insurance coverage on brokered deposits or restrictions on the rates payable for insured brokered funds also are viewed as unnecessary. However, market discipline cannot be relied on to control risk-taking in problem

institutions. As a bank nears insolvency the incentive for self-preservation may lead unprotected creditors and bank management to encourage the very risk-taking that is viewed as imprudent when the bank is healthy. As a bank's condition deteriorates, less reliance can be placed on market mechanisms and more reliance must be placed on the supervisory process.

Supervision

In addition to market discipline, supervision is the other major vehicle for controlling bank risk-taking. Rather than diminish its role, deregulation and other changes in financial markets have made the supervisory role even more critical. In Chapter 5, "Supervision," the role and effectiveness of the supervisory process is examined and recommendations for reform are put forth. Three major areas of the supervisory program are reviewed: the examination program, enforcement authority, and the applications process.

The examination program is the primary mechanism for monitoring the risk of individual institutions and for implementing necessary corrective actions. Several areas are identified as needing reemphasis or improvement.

First, because the FDIC's resources are at stake, the authority for the insurer to examine all insured banks needs to be clarified and strengthened.

Second, the regulatory agencies must improve their methods of identifying risk, setting priorities and allocating resources. This includes: (a) improved offsite monitoring through continued development of computer-assisted analyses of bank and industry data; (b) development of online information retrieval systems which will allow regulators computer access to at least the top tier of banks and those that exhibit more than normal risk; (c) development of diversification rules and systems and programs for analyses of industry sectors and geographical groupings in a way that will help focus supervision on potential or emerging problems; and (d) coordination of the information-gathering processes to more systematically establish priorities for onsite examinations of banks that still have satisfactory ratings.

Third, federal bank regulatory agencies must reemphasize and develop better ways to work together and streamline the examination process and information flows between agencies. This includes a rejuvenation of the cooperative examination program whereby the FDIC accompanies the OCC and the Federal Reserve Board in examinations of banks, and the consideration of issuing regional supervisory directives, i.e., alerts to examiners and bankers concerning a local or regional problem that need not wait for a nationwide pronouncement from the Washington offices.

Fourth, an effective examination program is dependent on maintaining a staff of highly skilled, experienced and well-compensated professionals. This means avoidance of periodic hiring freezes, maintenance of a benefits package that is competitive with the private sector, and development or acquisition of specialized expertise to deal with new and changing banking activities.

Finally, the supervision program could be further enhanced by establishing regional economic oversight committees comprised of representatives from different supervisory agencies to evaluate levels of risk in their respective areas. These committees would consult with industry and academic representatives and should seek to anticipate adverse economic trends.

When a bank does not operate in a safe-and-sound manner, regulatory authorities must possess the necessary tools to curb improper behavior. While the types of enforcement tools now available to the FDIC are generally adequate, expanding their applicability and streamlining their implementation would be helpful to the enforcement process. Several recommendations are made.

First, termination of federal deposit insurance should be streamlined to take no more than six months. Existing deposits would continue to be insured for a reasonable period following termination.

Second, capital laws or regulations should be rewritten to clarify restrictions that could be imposed on banks with capital levels below minimum standards. These might include suspension of dividends, restrictions on growth and a prohibition on acquisitions.

Controlling and monitoring risk through the supervisory process also could be enhanced by modifications to the applications process. At present, only state nonmember banks are required to apply to the FDIC for entry into the deposit insurance system. National and state member banks receive FDIC membership automatically upon approval of the OCC or the Federal Reserve.

When granting a charter, the chartering authorities should be required to consider the institution's risk to the insurance fund, using standards developed by the insurer.

Forbearance

Not only does deposit insurance reform require decisions on how much authority to grant bank supervisors, it requires decisions on the amount of discretion to be allowed the supervisor in the exercise of that authority. The trade-off between mandatory rules versus supervisory discretion underlies the discussion in Chapter 6 on "Forbearance." This chapter argues that these are circumstances where it may be appropriate for supervisors to exercise discretion in the face of excessive risk exposure by insured depository institutions; mandatory or rigid enforcement rules run the risk of undermining supervisory efforts to control risks. As used in this context, forbearance should be a deliberate act aimed at achieving control of risk, rather than the consequence of inaction or unwillingness to address problem situations. Many forms of forbearance have been successful in controlling risks, promoting sound operations, and limiting loss to the insurance fund. In Chapter 6 it is argued that the ability to exercise discretion is an important and, in fact, a necessary part of the supervisory process.

Failure Resolution

Chapter 7, "Failure Resolution," reviews alternative failure-resolution policies and evaluates their desirability in terms of how well they meet major policy objectives. As discussed elsewhere, a trade-off exists between the desire to maintain market discipline against bank risk-taking and the need to maintain public confidence and stability in the banking system. There appears to be substantial market discipline against risk-taking by healthy institutions. It is when a bank encounters financial difficulty that market discipline fades and the incentive to take risks becomes significant. These risk-taking incentives in problem institutions mean it is critical to maintain strong and effective supervision, which includes enforcement of appropriate capital standards and a general policy that calls for timely closure of insolvent institutions.

The view that the trade-off between stability (the prevention of bank runs) and depositor discipline must be weighted heavily in favor of stability is the driving force behind the first two recommendations in Chapter 7. First, because market discipline declines as capital levels decline, timely closure of insolvent institutions is a critical element in controlling risk. Further, since loan-loss reserves represent losses that already are anticipated, it should be clarified that chartering authorities should use equity capital rather than a capital measure that includes loan-loss reserves as the appropriate measure for determining solvency. Second, it would be desirable for the FDIC to have clear authority to distinguish between depositor and nondepositor claims in failure-resolution transactions. Such authority would give the FDIC greater flexibility to increase nondepositor discipline against bank risk-taking without risking greater instability in the banking system (through the introduction of greater depositor discipline and the increased possibility of bank runs).

Other recommendations in Chapter 7 would increase the FDIC's ability to maintain adequate funding against potential future problems. First, since evidence concerning the disposition of failed-bank assets suggests that it is more cost-effective to keep assets in the private sector rather than in a government liquidation, the current policy of passing as many failed-bank assets as possible to the acquiring bank should be maintained. Second, in order to eliminate the problems associated with affiliated banks operating as a single entity in good times, but as separate corporate entities in bad times, all federally insured banks should be required to protect the FDIC against losses in any banks owned by a common parent.

Issues Related to Handling Large-Bank Failures

The open-bank assistance provided to Continental Illinois National Bank and Trust Company in 1984 focused the "too-large-to-fail" discussion on banking and the way the FDIC approaches failing- and failed-bank situations. The FDIC always has handled the failure of larger banks in a way that results in full protection to depositors and other general creditors of the bank; on the other hand, uninsured creditors in smaller banks on occasion have been subjected to loss.

Since 1951, the FDIC has followed a set of rules that has forced identification of situations that are handled outside of normal criteria. Specifically, the FDIC must determine whether an institution is "essential" to the community in order to justify any transaction that is more costly than a deposit payoff and liquidation. This system has had two effects. First, the

form of this "cost test" is biased towards preserving franchise values were they exist; the result has been a higher likelihood of handling larger banks in a manner that protects all general creditors. Second, the FDIC is forced to explicitly justify any action that cannot be rationalized under the cost test. Thus, the term "too-large-to-fail" is inappropriate in the context of banking; a more appropriate term is "too-important-to-pay-off."

Moreover, the ability to deviate from decisions based solely on the cost test has had a long history and, more importantly, is likely to continue to be a fact of life--i.e., the "too-important-to-pay-off" doctrine in all probability is here to stay. That is to say, there will continue to be certain situations where an individual bank will be perceived to be too important to macroeconomic considerations or international stability to allow to be handled in a way that would inflict losses on bank creditors. This becomes increasingly true as other countries provide de jure or de facto 100 percent coverage to their banks, and as banking and finance become more international in scope. Thus, it would be counterproductive to design a system that does not accommodate this reality.

To the extent that handling bank failures involves broader macroeconomic considerations, some have questioned the appropriateness of vesting this responsibility with the deposit insurer. In Chapter 8, it is suggested that in the U.S. the insurance agency is appropriate for this purpose. First, the responsibility has been with the FDIC since 1934, and the system has worked reasonably well. Second, the way other countries allocate this responsibility--often to the central bank or ministry of finance--is not necessarily appropriate for the U.S. since relationships between government and banking are often much different in those countries. Third, the nature of banking makes it important to act rapidly in a failure situation; this would not be consistent with exposing failure resolution to short-term political influence. Finally, failure resolution creates an interest in maintaining certain asset values; this interest normally will not be consistent with the conduct of appropriate monetary policy.

Resolving the FSLIC Problem

The difficulties experienced by the FSLIC and S&Ls during the 1980s have been the major impetus behind calls for insurance reform. Chapter 9 assesses the extent of the problem and outlines a number of options for dealing with the FSLIC crisis.

The FSLIC shortfall is probably between $60 billion and $115 billion, including $10 billion to $15 billion to provide for an ongoing S&L insurance fund. This is well in excess of the resources available to FSLIC. Because these losses continue to grow, insolvent S&Ls should be closed as quickly as possible and reforms instituted to minimize the chance of existing problems recurring.

The S&L industry should bear as much of the cost as possible. However, severe constraints exist on the ability of the S&L industry to finance the FSLIC shortfall--the tangible net worth of all solvent S&Ls is only $40 billion, or four percent of their assets. There is a substantial risk that extensive use of S&L industry resources could drive presently healthy S&Ls

into insolvency or marginal solvency, and result in insurance-avoidance tactics, pressure to change insurers and increased risk-taking.

The banking industry also does not have the means to pay for the problem. Moreover, from an equity viewpoint, there is no reason why banks should pay for the S&Ls' problems. FDIC resources also should not be used due to the risk of leaving the agency with insufficient funds to fulfill its function.

The federal government must pick up most of the tab for the S&L problem. Concerns about the federal budget deficit could be mitigated by an off-budget financing arrangement, whereby the Treasury pays the interest and guarantees the principal of borrowings by a limited-life quasi-governmental agency. The recently created Farm Credit System Financial Assistance Corporation is an example. Off-budget financing has the advantage that it could avoid the politicalization of deposit insurance, which would seem inevitable if the costs were financed by appropriations.

Ensuring that current problems do not recur is at least as important as finding a short-term financial solution. The fundamental objective of a "regulatory solution" should be strong government regulation of the S&L industry instead of the *de facto* self-regulation which was a major cause of current problems. Under any scenario in which the FHLBB or FSLIC remain intact, FSLIC should be independent of FHLBB; the FHLBs should provide liquidity for housing, not supervise or examine the S&L industry; and the number of politically appointive positions in the FHLBB ought to be sharply reduced. In addition, in any scenario, banks and thrifts should be regulated according to common standards.

In terms of balancing the objectives of rapid resolution of insolvencies and minimizing the chance that current problems will recur, a recapitalization of FSLIC with reforms to the FHLBB and the FSLIC, an administrative merger of FSLIC into FDIC, or the creation of a new deposit insurance agency combined with more comprehensive reform of the thrift industry are the most desirable options. Other options considered and deemed less desirable in terms of balancing these objectives include a recapitalization of FSLIC without reforms; an immediate full-scale merger of FSLIC and FDIC; a conversion of healthy S&Ls to FDIC insurance, with FSLIC or some other agency resolving the remaining cases; and a complete restructuring of the financial institutions regulatory system.

The three possible options that satisfy the requirements set forth in Chapter 9 can be called: (A) A stand-alone FSLIC; (B) An administrative merger of FSLIC into FDIC; and (C) Comprehensive reform of the thrift regulatory structure. The FDIC favors option A.

A stand-alone FSLIC envisions the creation of a separate FSLIC that is independent of the Federal Home Loan Bank Board (FHLBB). The FHLBB would continue to charter and supervise federal thrift institutions and would run both the Federal Home Loan Bank System and the Federal Home Loan Mortgage Corporation (Freddy Mac). The newly-separated FSLIC would directly supervise all state-chartered thrifts and be responsible for all liquidation activities related to FSLIC-insured institutions. The FSLIC would not be subject to the

appropriations process. The district Federal Home Loan Banks would no longer examine or supervise thrifts. Their role would be confined to providing liquidity for institutions meeting housing-related criteria. System membership would be available to any depository institution meeting these criteria.

The second option is an administrative merger of FSLIC into FDIC. There would be common management and an administrative Board over separate FDIC and FSLIC funds. The new FDIC would supervise state-chartered thrifts and state-chartered banks that were not members of the Federal Reserve System and would perform all liquidation activities for insured banks and thrifts.

The third option calls for comprehensive reform of the thrift regulatory structure. An administrative merger of FSLIC and FDIC would occur, creating a new federal deposit insurance corporation for banks and thrift institutions. The Office of the Comptroller of the Currency (OCC) would assume responsibility for chartering and supervising federal thrifts and the Federal Reserve Board would supervise thrift holding companies. The FHLBB would continue to oversee the Federal Home Loan Bank System and Freddy Mac, under the umbrella of the Department of Housing and Urban Development or the Federal Reserve Board.

Conclusions

In addition to the conclusions outlined thus far, Chapter 10 outlines some other broader conclusions and recommendations. One of these conclusions is that the provision of deposit insurance should not interfere with the industry's adaptation to the technological changes affecting financial markets, regardless of whether these changes imply an expanded or more limited role for traditional banking activities. This is consistent with the recommendations of the FDIC's Mandate for Change study, which was published in 1987.

In Mandate for Change, it was argued that firewalls could be established between bank and nonbank affiliates to prevent the use of insured deposits for nonbanking activities, thus eliminating a potential advantage that banking organizations may have over nonbanking organizations. At the same time, the limitations imposed on the types of businesses that may own a bank place artificial restrictions on legitimate economies of scope and the flow of capital and other resources into and out of the banking industry. By eliminating these restrictions, it will be easier for the banking industry to adjust to the technological changes that are occurring, while ensuring that funding advantages are not given to nonbank entities.

The ability of the industry to adapt to technological and economic changes also would be enhanced by allowing for a more orderly entry into and exit from the industry. Restrictions on intrastate branching and interstate banking impede the orderly entry into and exit from the industry, and increase the FDIC's costs of resolving failures. In addition, these restrictions limit loan diversification, thereby increasing risks to the system. The elimination of these geographic restrictions would allow the industry to be more responsive to changing financial conditions and regional difficulties.

Throughout the chapters of this Study, questions concerning the trade-off between financial stability and market discipline are raised. Reform proposals that call for greater market discipline have the potential to reduce the risk-taking incentives that deposit insurance provides, but they also have the potential to create costs by increasing the chances of bank runs.

Underlying reform proposals that call for greater amounts of market discipline, by strictly enforcing de jure coverage or rolling back the insurance coverage, is the view that markets (deposit markets) are relatively efficient at evaluating bank risk and that costs of the increased chances of bank runs are relatively low. Thus, in this view, the benefits of increased depositor discipline outweigh the costs.

In this Study the view is that existing forms of market discipline in well-capitalized banks, when combined with prudent supervision, are sufficient to control any incentives for excessive risk-taking by banks caused by the existence of deposit insurance. At the same time, it is the FDIC's view that bank runs or the threat of bank runs can be costly, and that any moves toward enhancing market discipline must seriously weigh these potential costs. Consequently, the Study stresses the need to enhance existing forms of market discipline; to strengthen supervision so that overly risky behavior is detected and controlled in a timely manner; to maintain strict capital standards and ensure that insolvent institutions are promptly closed; and to provide insuring agencies with the proper incentives so as to facilitate the long-term viability of the federal deposit insurance system.

APPENDIX A to Chapter 9

PROGRAM FOR DEPOSIT INSURANCE REFORM AND AGENCY RESTRUCTURING

SUMMARY

The following summary and outline set forth a program for deposit insurance reform. Part I contains three alternative plans for agency restructuring as part of the resolution of the FSLIC situation. Part II proposes options for resolving the FSLIC/thrift crisis and Part III recommends deposit insurance reforms generally.

The three plans for agency structural reforms are:

- Plan A -- Creation of a separate FSLIC that is independent of the FHLBB. The FHLBB would maintain its current Board composition and continue to charter and supervise federal thrifts and run both the Home Loan Home Bank System and Freddy Mac. The newly-separated FSLIC would, generally, mirror the FDIC. It would supervise all state-chartered thrifts and be responsible for all thrift liquidation activities -- including the resolution of insolvent thrift cases and FADA. The composition of the FSLIC Board, its degree of administrative independence and its authorities and responsibilities would track those of the FDIC. Thus, the Chairman of the FHLBB would be on the FSLIC Board, in the same manner as the Comptroller is on the FDIC Board. Given a choice, the FDIC would prefer Plan A.

- Plan B -- Administrative merger of the FSLIC into the FDIC. The FHLBB would maintain its current Board composition and perform the same functions as under Plan A. However, the FSLIC would be administratively merged into the FDIC. Two new members would be added to the FDIC Board, including the FHLBB Chairman and an additional outside director. In addition to administering the two separate funds, the FDIC would supervise state-chartered thrifts and nonmember banks and perform all liquidation activities for all insured thrifts and banks. Its responsibilities would include disposition of insolvent thrift cases and FADA.

- Plan C -- Comprehensive reform of the deposit insurance system and the supervisory structure. This Plan involves a new Insurance Corporation headed by a politically independent 5-person Board that administers both the bank and thrift insurance funds. Plan C also revises the supervisory structure for all thrift institutions. The OCC would assume responsibility for chartering and supervising federal thrifts and the FRB would be responsible for thrift holding companies. The FHLBB would continue to oversee the FHL Bank System and Freddy Mac under the umbrella of HUD or the FRB.

Following the three plans for agency restructuring, the outline contains recommendations for the FSLIC/thrift crisis (Part II) and deposit insurance reform recommendations (Part III).

PROGRAM FOR DEPOSIT INSURANCE REFORM AND AGENCY RESTRUCTURING

OUTLINE

The following describes a program for deposit insurance reform and resolution of the FSLIC crisis, as well as three alternative plans for agency restructuring. The document consists of three parts:

I. Three alternative plans for agency restructuring

   PLAN A - Creation of a separate FSLIC that is independent of the FHLBB (The FDIC favors this Plan)

   PLAN B - Administrative merger of FSLIC into FDIC

   PLAN C - Structural reform of deposit insurance, chartering and supervisory agencies

II. Recommendations for the FSLIC/thrift crisis

III. Deposit insurance reforms generally

I. Three Alternative Plans for Agency Restructuring

The description of each plan will include: objectives; a diagram of agency structure and functions; and an outline describing the plan.

PLAN A

AN INDEPENDENT FSLIC SEPARATE FROM THE FHLBB

Objectives of Plan A

- Separate the FSLIC from the FHLBB
- Avoid "micro-management" by statute of the FSLIC and its mandate -- i.e., allow the FSLIC flexibility to manage the current crisis subject to general guidelines and standards set forth by Congress and require it and the FDIC to make long-range recommendations to the Congress
- The FSLIC should be "off budget" and independent of the appropriations process (FDIC also should be moved "off budget")
- Work toward regulatory and supervisory standards for thrifts that are comparable to those for banks

Outline of Plan A

A. The FSLIC would be separated from the FHLBB and, generally, the FSLIC would be a mirror image of the FDIC. This is the Plan that is preferred by the FDIC.

1. Board composition - The FSLIC would have a three-person Board. The Chairman of the FHLBB would be on the Board in the same manner as the Comptroller is on the FDIC Board. However, the FHLBB Chairman could not chair the FSLIC.

2. The FSLIC and its budget would not be subject to the appropriations process and would have the administrative independence of a "mixed ownership corporation" (patterned after FDIC).

3. Prospectively, the FSLIC would be the insurer for only those institutions that operate as thrifts -- i.e., those that meet the qualified thrift lender (QTL) or some similar "housing-related" standard.

4. Authorities and responsibilities of the FSLIC.

   a. The FSLIC -- like the current FDIC -- will be charged with protecting insured depositors, the integrity of the insurance fund and the safety and soundness of the FSLIC-insured system.

   b. The FSLIC is to be responsible for all thrift liquidation activities -- including resolution of insolvent thrift cases and FADA. Segregating insolvent thrifts under a separate entity (the "separate trust" concept) and having a separate liquidating entity (FADA) are both unworkable and could substantially increase the ultimate losses.

   c. The FSLIC is to be the primary federal supervisor for all state-chartered thrifts.

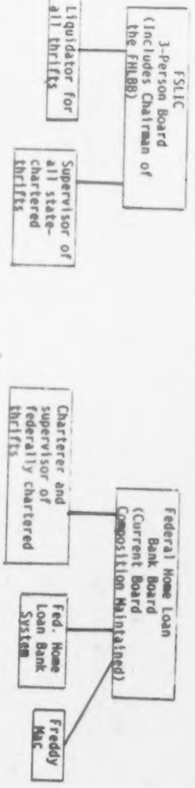
   d. The FSLIC will have the same authorities and powers relative to state and federally chartered thrifts that the FDIC now has with respect to state and federally chartered banks (subject to the enhanced authorities recommended in III).

   e. The FSLIC is required to adopt standards for thrifts that are comparable to those for banks -- i.e., capital, accounting, liquidity, lending limits and other safety and soundness standards.

   f. The FSLIC (and the FDIC) will be charged by Congress to make recommendations within one year for further reforms.

4. Some of the existing experienced Federal Home Loan Bank examiners would be allocated to the FSLIC.

DIAGRAM OF PLAN A -- AN INDEPENDENT FSLIC


FSLIC
3-Person Board
(Includes Chairman of the FHLBB)
Liquidator for all thrifts
Supervisor of all state-chartered thrifts
Federal Home Loan Bank Board
(Current Board Composition Maintained)
Charterer and supervisor of federally chartered thrifts
Fed. Home Loan Bank System
Freddy Mac

Functions

- Perform all liquidation activites -- including resolution of all insolvent thrift cases and asset liquidations (would have responsibility for FADA)
- Supervise all state-chartered thrifts
- Make recommendations (along with the FDIC) to Congress for further reforms

Functions

- FHLBB charters and supervises federal thrifts and oversees thrift holding companies. (FHL Banks no longer supervise thrifts)
- Promote housing through the FHL Banks
- Provide funding through the FHL Banks for institutions that meet specified "housing" or other criteria
- Oversee Freddy Mac (which ultimately could be privatized)

B. Federal Home Loan Bank Board

1. Federally chartered thrifts would continue to come under the jurisdiction of the FHLBB. The FHLBB would:
    - a. Charter federal thrifts.
    - b. Implement and administer the Home Owners' Loan Act.
    - c. Supervise and examine federal thrifts (this would remove this function from the Home Loan Banks -- which is desirable since they are not independent of the industry).
    - d. Administer the S&L Holding Company Act.
2. The FHLBB would continue to oversee the Federal Home Loan Bank System and Freddy Mac. However, changes would be necessary to the FHLB System.
    - a. The System would no longer supervise or examine thrifts.
    - b. System membership would be available to other institutions that meet prescribed "housing" or other specified criteria.
    - c. Over the long term, it may be advisable to completely privatize Freddy Mac.

PLAN B

ADMINISTRATIVE MERGER OF FSLIC INTO FDIC

Objectives of Plan B

- Separate the FSLIC from the FHLBB
- Provide for an administrative merger of the FSLIC i[illegible] the FDIC
- The "new FDIC" should be moved "off budget"
- Avoid "micro-management" by statute of the new FDIC and its mandate -- i.e., allow the FDIC flexibility to manage the current crisis subject to general guidelines and standards set forth by Congress and require it to make long-range recommendations to the Congress
- Work toward comparable insurance premiums and common standards of regulation and supervision for banks and thrifts

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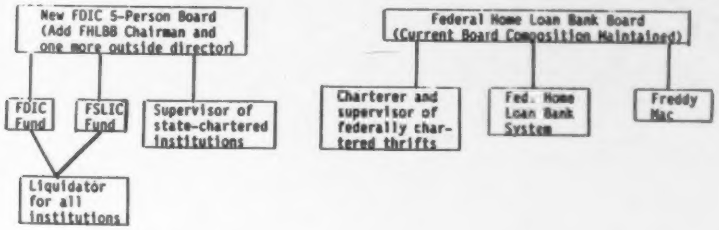
DIAGRAM OF PLAN B -- ADMINISTRATIVE MERGER OF FSLIC INTO FDIC


New FDIC 5-Person Board (Add FHLBB Chairman and one more outside director)
FDIC Fund
FSLIC Fund
Supervisor of state-chartered institutions
Liquidator for all institutions
Federal Home Loan Bank Board (Current Board Composition Maintained)
Charterer and supervisor of federally chartered thrifts
Fed. Home Loan Bank System
Freddy Mac

Functions

- Administer two separate insurance funds -- FDIC and FSLIC
- Perform all liquidation activities -- including resolution of all insolvent thrift cases and asset liquations (would have responsibility for FADA)
- Supervise state-chartered thrifts, as well as state nonmember banks
- Make recommendations to Congress for further reforms

Functions

- FHLBB charters and supervises federal thrifts and oversees thrift holding companies (FHL Banks no longer supervise thrifts)
- Promote housing through the FHL Banks
- Provide funding through the FHL Banks for institutions that meet specified "housing" or other criteria
- Oversee Freddy Mac (which ultimately could be privatized)

Outline of Plan B

A. The FSLIC would be administratively merged into the existing FDIC. The FDIC would have responsibility for administering the two funds, taking care of the insolvent thrift institutions (see II) and making recommendations to the Congress for further reforms.

1. FDIC Board Composition

   a. The FDIC Board would be expanded to include the FHLBB chairman and an additional outside director.

   b. No more than two of the three outside directors could be of the same political party.

2. Authorities and responsibilities of the new FDIC.

   a. The FDIC is to administer two financially separate and distinct funds. Two separate premium income streams are to continue to be allocated to the separate funds. Expenses are to be charged against, and reserves allocated to, the appropriate fund.

   b. The FDIC is to be responsible for all liquidation activities -- including resolution of insolvent thrift cases and FADA (which probably would be phased out). Segregating insolvent thrifts under a separate entity (the "separate trust" concept) and having a separate liquidating entity (FADA) are both unworkable and could substantially increase the ultimate losses.

   c. The FDIC is to be the primary federal supervisor for state-chartered thrifts, as well as nonmember banks.

   d. The FDIC has complete authority to determine the administrative structure of the agency.

   e. The FDIC has the same authorities and powers relative to state and federally chartered thrifts that it now has with respect to state and federally chartered banks (subject to the enhanced authorities recommended in III).

   f. The FDIC is charged by Congress to make recommendations within one year for further reforms over and above those made at the time of enactment of the legislation that administratively merges the FSLIC into the FDIC. (See III)

4. Some of the existing experienced Federal Home Loan Bank examiners would be allocated to the new FDIC.

B. Federal Home Loan Bank Board

1. Federally chartered thrifts would continue to come under the jurisdiction of the FHLBB. The FHLBB would:

   a. Charter federal thrifts.

   b. Implement and administer the Home Owners' Loan Act.

   c. Supervise and examine federal thrifts (this would remove this function from the Home Loan Banks).

   d. Administer the S&L Holding Company Act.

2. The FHLBB would continue to oversee the Federal Home Loan Bank System and Freddy Mac. However, changes would be necessary to the FHLB System.

   a. The System would no longer have overall responsibility for supervising thrifts.

   b. System membership would be available to other institutions that meet prescribed "housing" or other specified criteria.

   c. Over the long term, it may be advisable to completely privatize Freddy Mac.

PLAN C

REFORM OF THE DEPOSIT INSURANCE SYSTEM AND THE SUPERVISORY STRUCTURE

Objectives of Plan C

- Separate the FSLIC from the FHLBB
- Provide for common management of the FSLIC and the FDIC by a politically independent Corporation that is responsible for all FSLIC and FDIC-insured institutions -- including the currently insolvent thrifts
- The Insurance Corporation should be "off budget" and independent of the appropriations process
- Avoid "micro-management" by statute of the new Corporation and its mandate -- i.e., allow the Corporation flexibility to manage the current crisis subject to general guidelines and standards set forth by Congress and require it to make long-range recommendations to the Congress
- Work toward comparable insurance premiums and common standards of regulation and supervision for banks and thrifts
- Create a structure for chartering and supervising federal thrifts and thrift holding companies that tracks that of banks.

Outline of Plan C

The new structure entails breaking up the existing FHLBB structure and moving most of its functions elsewhere. This accomplishes the following objectives: (1) separates the charterer of federal thrifts from the insurer; (2) allows for an administrative merger of the FDIC and FSLIC; (3) consolidates the chartering and supervision of federal thrifts with that of national banks; (4) consolidates the federal regulation and supervision of most state-chartered institutions in one agency; (5) consolidates the regulation and supervision of all holding companies in one agency; and (6) maintains the important functions of the Federal Home Loan Bank System.

A. Insurance Structural Reform - An administrative merger of the FDIC and the FSLIC. This envisions a government-controlled Corporation (hereinafter the "Corporation") that administers two separate and distinct insurance funds. The Corporation is to have responsibility for administering the two funds, taking care of the insolvent thrift institutions (see II) and making recommendations to the Congress for further reforms.

1. Corporation composition - Managed by a board of directors (the "Board") which is structured to promote political independence (similar to the structure of the FRB).

   a. Five-person Board with long, staggered fixed terms (recommend 8-year terms).

   b. President appoints Chairman from the Board for a shorter term (possibly a 4-year term).

   c. The Comptroller of the Currency would be on the Board in the same manner as the Comptroller is now on the FDIC Board.

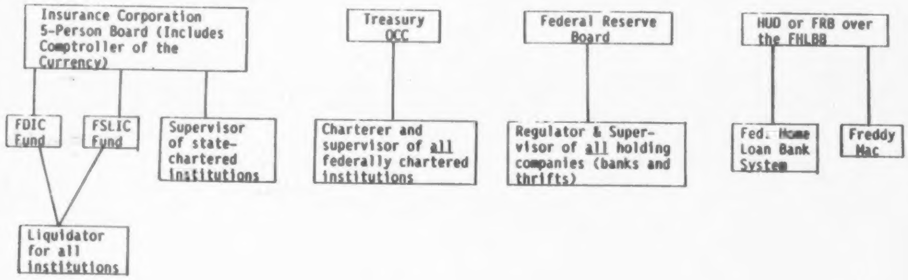
   d. No specified political composition (although initial Board should have no more than three persons from the same political party to avoid "stacking" the first Board).

2. The Corporation and its budget would NOT be subject to the appropriations process and would have the administrative independence of a "mixed ownership corporation" (patterned after FDIC).

3. Authorities and responsibilities of the Corporation.

   a. The Corporation is to administer two financially separate and distinct funds. Two separate premium income streams are to continue to be allocated to the separate funds. Expenses are to be charged against, and reserves allocated to, the appropriate fund.

DIAGRAM OF PLAN C -- REFORM OF DEPOSIT INSURANCE AND SUPERVISORY SYSTEMS


Insurance Corporation 5-Person Board (Includes Comptroller of the Currency)
FDIC Fund
FSLIC Fund
Supervisor of state-chartered institutions
Liquidator for all institutions
Treasury OCC
Charterer and supervisor of all federally chartered institutions
Federal Reserve Board
Regulator & Supervisor of all holding companies (banks and thrifts)
HUD or FRB over the FHLBB
Fed. Home Loan Bank System
Freddy Mac

- Administer two separate insurance funds - FDIC and FSLIC
- Perform all liquidation activities -- including resolution of all insolvent thrift cases and asset liquidations (would have responsibility for FADA)
- Supervise state-chartered thrifts and state nonmember banks
- Make recommendations to Congress for further reforms

- Charter both nat'l banks & fed. thrifts
- Supervise both nat'l banks & fed. thrifts
- Administer both the National Bank Act and Home Owners' Loan Act
- Comptroller to be on the Board of the Insurance Corporation

- Regulate & supervise both bank & thrift holding companies
- Continue to supervise state member banks
- Continue monetary policy function
- Continue to administer payment system

- Promote housing through the FHL Banks
- Provide funding through the FHL Banks for institutions that meet specified "housing" or other criteria
- FHL Banks no longer supervise thrifts
- Oversee Freddy Mac (which ultimately could be privatized)

b. The Corporation is to be responsible for all liquidation activities -- including resolution of insolvent thrift cases and FADA. Segregating insolvent thrifts under a separate entity (the "separate trust" concept) and having a separate liquidating entity (FADA) are both unworkable and could substantially increase the ultimate losses.

c. The Corporation is to be the primary federal supervisor for state-chartered thrifts and nonmember banks.

d. The Corporation has complete authority to determine the administrative structure of the agency.

e. The Corporation has the same authorities and powers relative to state and federally chartered banks and thrifts that the FDIC now has with respect to state and federally chartered banks (subject to the enhanced authorities recommended in III).

f. The Corporation is charged by Congress to make recommendations within one year for further reforms over and above those made at the time of Corporation formation. (See III)

4. The existing experienced Federal Home Loan Bank examiners would be transferred to the new Corporation, the OCC and the FRB.

B. Federally Chartered Thrifts

1. Federally chartered thrifts would come under the jurisdiction of the OCC.

2. The OCC would perform the same functions for federal thrifts that it now performs for national banks. It would:

a. Charter federal thrifts.

b. Implement and administer the Home Owners' Loan Act.

c. Supervise and examine federal thrifts (this would remove this function from the Home Loan Banks -- which is desirable since they are not independent of the industry).

C. Thrift Holding Companies

1. Regulation and supervision of thrift holding companies under the S&L Holding Company Act would be given to the FRB.

D. Federal Home Loan Bank System/Freddy Mac - The FHLBB would continue to oversee the FHL Bank System and Freddy Mac under the umbrella of HUD or the FRB.

1. The FHLB System would maintain much of its current functions.

a. It would have a mandate to promote housing.

b. It would provide funding to the industry.

2. Changes would be necessary to the FHLB System.

a. The System would no longer supervise or examine thrifts.

b. System membership would be available to other institutions that meet prescribed "housing" or other specified criteria.

c. Over the long term, it may be advisable to completely privatize Freddy Mac.

II. Recommendations for the Thrift/FSLIC Crisis

A. Resolution of the crisis would be the responsibility of the insurance agency (i.e. FSLIC under Plan A, FDIC under Plan B and the new Corporation under Plan C), following a program mandated by Congress.

B. The mandate to the insurer would be as follows:

1. To resolve the worst 100 first (estimates are that it will take about $30 billion and at least six months to resolve the 100 or so "worst" institutions).

2. To resolve the rest of the insolvent thrift cases subject to Treasury and Congressional oversight over an extended period.

a. Funding could be subject to a requirement that periodic draws be approved by Treasury.

b. Periodic progress reports to Congress also would be required.

C. Broaden potential acquirors for troubled thrifts by mandating that the FRB eliminate the restrictions imposed on bank holding company acquisitions of such thrifts.

D. Funding

1. Funding would be a combination of government borrowing and thrift industry resources (to the extent that the industry can shoulder the burden), including tapping some of the resources of the Federal Home Loan Bank System.

2. The insurance agency(ies) should be on a "separate budget" that is subject to Congressional oversight.

3. The insurer should be permitted to borrow, unsecured, from the FRB (or Treasury) at a rate no higher than the Fed discount rate.

4. The special 1/8 of 1% thrift premium assessment and the moratorium on conversions to the FDIC should be addressed by Congress.

   a. Under Plan A, the special premium would extend for at least one year and the moratorium would terminate when assessments return to normal.

   b. Under Plans B and C, the FDIC or the new Corporation, respectively, would be responsible for making determinations regarding the special assessment and the conversion of institutions from one fund to the other.

III. Deposit Insurance Reforms Generally

These reforms would be contained in the legislation creating the new insurance structure. They would be permanent reforms to the deposit insurance system that would apply to the insurance agency(ies) (i.e. Both FSLIC and FDIC under Plan A, the new FDIC under Plan B or the new Corporation under Plan C).

A. Insurance premiums that reflect the experience of the insurer(s) would be authorized. The insurer would be permitted to increase or decrease premiums as called for by insurance expenditures.

   1. The basic formula would be set out in the law.

   2. If there is a common administrative Board, at the outset the formula would be applied to each fund separately based on the experience of each separate fund. Over the long term, the objective should be to have the formula for establishing premiums the same for both industries.

B. With respect to federally chartered institutions and state member banks, the chartering authority would be required to certify to the insurer that each institution to which it grants a charter is eligible for insurance based on standards established by the insurer.

C. Insurers would be authorized to terminate insurance (i.e., take Section 8(a) action) much more rapidly -- in six months or less -- than under current law.

D. The enhanced enforcement authorities adopted by both House and Senate Banking Committees in the 100th Congress would be enacted.

E. The insurer would be authorized to establish minimum capital standards for all insured institutions in cooperation with the chartering authorities.

F. Insured institutions in holding companies would be required to guarantee their insurer against any insurance losses caused by other insured institutions in the holding company.

G. The insurer(s) would be mandated to make standards of regulation and supervision for banks and thrifts uniform over time.

H. The insurance agency(ies) would be moved "off budget" and removed from the budget process.

I. The insurance agency(ies) and other federal regulatory authorities would be required to make further reform recommendations to the Congress in prescribed areas, including the following:

   1. Merger of the two separate insurance funds (or, under Plan A, the two separate agencies).

   2. Additional powers (enforcement and otherwise) required by the insurer to protect the insurance funds.

   3. Whether there is a need for restructuring of the credit union agency structure -- such as separating the NCUSIF from the NCUA.

   4. Comprehensive long-term reforms to the insured financial institutions industry that are necessary to allow those institutions to attract capital and be competitive both at home and abroad. Industry reforms to be considered are:

      a. Permitting an array of activities outside the boundaries of the insured institution itself that are patterned after those permitted unitary thrift holding companies (i.e., unlimited activities).

      b. Strict firewalls around insured institutions and strict supervision and enforcement of the firewalls.

      c. Permitting activities that are required to be outside the "insurance wall" to be conducted either in holding companies or subsidiaries.

      d. Requiring investment in any activities that are impermissible to the insured institution itself to be out of excess capital.

      e. Providing the insurer with clear authority to require any institution to move an activity that the insurer deems inappropriate for insurance coverage outside the insured entity -- into its parent, a affiliate or a subsidiary.

Term of Chairman

Section 203(2) of FIRREA, amending Section 2 of the FDI Act, should read:

(2) by deleting the second sentence thereof and inserting the following:

One of the appointive members shall be designated by the President, by and with the advice and consent of the Senate, to serve as Chairman of the Board for a term of four years, and one shall be designated by the President, by and with the consent of the Senate, to serve as Vice Chairman of the Board for a term of four years. Not more than two of the appointive members shall be members of the same political party.

Debt Limitation

Section 216(2) of FIRREA, amending Section 15 of the FDI Act, should read:

(2) by adding a new subparagraph (b) to read as follows:

(b) (1) The Corporation shall estimate the cost of all notes or similar obligations issued by it, and all guarantees or similar obligations incurred by it, prior to the creation thereof, and shall reflect such cost in its financial statements, and make such adjustments as are appropriate thereto no less frequently than quarterly.

(2) The Corporation shall not issue any note or similar obligation, and shall not incur any liability under a guarantee or similar obligation, with respect to either the Bank Insurance Fund or the Savings Association Insurance Fund if the estimated cost thereof would reduce the net worth of the respective Insurance Fund to less than zero.

(3) With the prior approval of the Secretary of the Treasury, the Corporation may issue or incur up to $5 billion in the aggregate of additional liabilities in excess of the limitations of (2) above; Provided, that, any such additional liabilities shall reduce, on a dollar for dollar basis, the amount which the Corporation may borrow from the Treasury under Section 14 of this Act.

(4) For the purposes of this subsection (b), the net worth of an Insurance Fund shall be calculated based upon the most recent audit of such Fund by the General Accounting Office, as reduced by the adjustments required in paragraph (1).

Reporting

Section 217(2) of FIRREA, amending Section 17 of the FDI Act, should read:

(2) By redesignating subsections (b), (c) and (d) as (c), (d) and (e), respectively, and by adding a new subsection (b) to read as follows:

Prior to the beginning of each fiscal quarter, the Corporation shall provide to the Secretary of the Treasury copies of the Corporation's financial operating plans and forecasts, and as soon as practicable following the close of each fiscal quarter, the Corporation shall provide to the Secretary of the Treasury copies of the report of the Corporation's financial condition and results of operations for such quarter. The plans, forecasts and reports shall reflect the liabilities and obligations as provided in Section 15(b)(1) of this Act. The requirement to provide the plans, forecasts and reports shall not imply any obligation on the part of the Corporation to obtain the consent or approval of the Secretary of the Treasury with respect thereto.

Firewalls for Risky Activities

Section 218(5) of FIRREA, amending Section 18 of the FDI Act, is changed by deleting the last sentence of §18(m)(3)(A), and inserting in lieu thereof the following:

In addition, if a Savings Association Insurance Fund member elects to conduct such activity indirectly, it shall deduct its entire investment in and loans or other financial accommodations to the company from its own capital for the purposes of determining capital adequacy, and shall conduct the activity in accordance with such rules, regulations or orders as the Corporation may establish to assure that the Savings Association Insurance Fund member does not become liable for the liabilities or obligations of the company or arising out of its activities.

The CHAIRMAN. Thank you very much, Chairman Seidman. As usual, your reputation for being direct and independent in your view is reaffirmed today and I accept the suggestions you've made fully in the spirit of supporting the package's general thrust and wanting to see us enact it quickly. But I think that some of the refinements that you've suggested today are very important ones and I appreciate your directness about it.

I want to acknowledge the other members that have come in for any brief opening comment they want to make before we start the question period. Senator Shelby.

Senator SHELBY. Mr. Chairman, I have an opening statement that I would ask unanimous consent be made part of the record and then I'll wait my turn on the questions.

The CHAIRMAN. It will be.

OPENING STATEMENT OF SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, I want to join with my colleagues in welcoming today's witnesses. Both of these gentlemen have been integral parts of the process of drafting the Bush proposal and have been very constructive throughout the debate on this issue.

I have skimmed your testimony and found your comments to be very helpful. You have both been willing to include comment on the areas where your experience causes you to differ from the administration's recommendations and your pointing out these areas of dissent, however slight, is very helpful.

Mr. Seidman mentions in his testimony something that I believe is very important. On page 12 he states that the FDIC believes that the projected premium increase for savings and loans from 20.8 basis points to 23 basis points is both "reasonable and apparently within the capacity of those institutions to pay." He follows, however, by saying that determinations of the industry's continued viability should be considered within the context that capital requirements will be significantly increased and dividends from the district banks in the Bank Board System will be eliminated.

That is a very important point. The present proposal attempts to take all the industry resources available to pay for the crisis resolution. I believe that that is appropriate. While I recognize that not all thrifts were responsible for this mess, there is some guilt by association, especially when one considers that it is either the taxpayer or the industry that's going to foot the bill. I support assessing the industry to the extent that is possible.

However, it is pointless at this juncture to put in place a solution that will only paper over the problems. The paper we will be using is expensive, we must use it judiciously. If we are setting up a "solution" that will force us to come back and repaper later, that is, will force us to bail out a significant number of thrifts made insolvent by the "solution", then history will prove today's efforts irresponsible and myopic.

The Bush proposal assumes that the continued viability of a separate thrift industry is desirable and it is true that thrifts still originate more than 50 percent of home mortgages today. While banks, mortgage banks, and other participants in the financial services industry continue to increase their role in the marketplace, eliminating the mortgage origination capacity now held by thrifts would be detrimental to home buyers. However, as Comptroller Clarke points out, the differences between thrifts and banks will continue to diminish regardless of "the regulatory framework adopted."

I believe that that is true. Therefore, I believe that it is important that we not levy more punitive assessments on the thrift industry than it can bear. Comptroller Clarke stresses that it is essential to create a level playing ground between thrifts and banks and I agree.

Gentlemen, I am interested in your opinions on what the S&L industry can safely bear, without significant damage to its continued viability. If we make the judgment that a separately chartered, separately regulated thrift industry is essential in promoting housing finance, we must provide for its strength.

I look forward to your testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, I have an opening statement that I ask unanimous consent that it be placed in the record.

The CHAIRMAN. Without objection.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I join you in welcoming the Chairman of the FDIC and the Comptroller of the Currency. When Bill Seidman revealed the FDIC's study on deposit insurance reform last year, he said he had been to the mountaintop and returned with the Ten Commandments for a better deposit insurance system. Now that we have the Ten Commandments, it is up to Congress to part the Red Sea of thrift industry losses and lead savings and loans to the Promised Land.

The President is all fired up to deal with this problem—you could say we have seen a burning Bush. The administration has offered us a plan that could lead to the thrift industry's salvation. It may well be the answer to our prayers for a speedy resolution to this crisis. The President's plan urges the thrift industry to reform its ways and to keep its faith in home finance. It requires that we take up a collection from the entire congregation, and gives some charity to an industry in need. The program also seeks to punish those who have sinned and stolen from the thrift industry.

Mr. Chairman, I continue to maintain my faith in the President's proposal. I may wish to stray from some of its provisions, but on balance, it contains the right spirit. The American people are ready to witness a congressional miracle of swift action to resolve this crisis. We have an opportunity that I hope this committee will not pass over.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bryan.

Senator BRYAN. Mr. Chairman, I will yield my time so we might get to the questions to Mr. Seidman.

The CHAIRMAN. Very good. Senator Bond.

Senator BOND. Sounds good to me.

The CHAIRMAN. Very good. Senator Dixon was here and left a statement for the record. He's over in the Armed Services Committee on the Tower issue.

I also have statements from Senators Cranston and Sasser for insertion in the record.

[Senators Dixon, Cranston, and Sasser opening statements follow:]

STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee continues its hearings on the thrift industry crisis. I look forward to hearing the testimony of the Chairman of the Federal Deposit Insurance Corporation [FDIC], William Seidman, and of the Comptroller of the Currency, Robert Clarke. As we review the administration's recapitalization and regulatory reform proposal, I know the committee will benefit greatly from the expertise that Chairman Seidman and Comptroller Clarke bring to this complex issue.

I have two concerns, which I outlined previously before this committee, that I hope our guests will address this morning: One, the ability of banks and thrifts to pay increased premiums and two, the ability of thrifts to meet increased capital standards.

We need to accomplish many objectives at once in addressing the thrift crisis: First, minimize the burden on taxpayers; second, restore effective regulatory supervision; and, third, avoid burdening the thrift and banking industries so severely that we end up with new problems, such as even more expensive insolvencies or an even smaller rate of savings.

How high can we raise premiums on thrifts and, separately, on banks, without causing new and unintended problems? Can we quickly increase capital standards on thrifts as we simultaneously raise premiums and eliminate the balance sheet use of goodwill?

I am searching for intelligent, honest, complete, and nonpartisan answers to these difficult questions. Working together, I am confident that this committee and the administration can fashion an effective legislative solution to the thrift industry problems. But, first, we need to get our facts straight.

Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. I welcome Mr. Seidman, the Chairman of the Federal Deposit Insurance Corporation, and Mr. Clarke, the Comptroller of the Currency, to the committee.

I could not attend the hearing last week when Secretary Brady introduced the administration's plan on the thrift crisis because I was in Japan with the delegation to Emperor Hirohito's funeral.

However, I want to congratulate the administration for moving so swiftly and comprehensively with a bold solution proposal to this very urgent problem. I understand that the FDIC has already acted expeditiously by taking charge of 200 or so thrifts and is moving toward other reforms.

The Congress will no doubt make some minor changes in this plan but by and large the administration has bitten the bullet and made all the tough choices that were on the table. These actions will make it easier for the Congress to move speedily in a bipartisan manner on this proposal.

Mr. Seidman, you struck out early on with a plan for resolving the FSLIC problem and now in this bill, the administration has put the whole ball of wax in your shop. I do not know if you will wear a crown of roses or thorns when this is all over, but I am pleased that you are there to handle this problem.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR SASSER

Senator SASSER. I am pleased that the committee will hear from two of our distinguished banking regulators—William Seidman and Robert Clarke—on the issue of the savings and loan crisis.

As we all know, President Bush's recommended plan dealing with the crisis places much of the responsibility with Mr. Seidman's agency, the FDIC. Indeed, the FDIC has already become involved by taking over several insolvent savings and loans from the FSLIC.

This is commendable. We are fortunate that we have the expertise and the resources of the FDIC available to us in this financial emergency.

I am looking forward to hearing the testimony that will be presented today. Mr. Chairman, I again compliment you on the scheduling of these important and exhaustive hearings, and I look forward to working with you on this critical legislation.

Thank you, Mr. Chairman.

The CHAIRMAN. With that, let me now begin the questioning period, Chairman Seidman.

You have prepared two charts at my request, and I appreciate the detailed work that that required and the fact that the work has been done.

As best you can, would you now please describe the administration's financing package, how it appears to work, and make whatever relevant comparisons there are to be made to what I also asked you to prepare and that would be a simplified more direct kind of financing mechanism. I'd like, if you would, to give us a sense as to what these two charts illustrate.

EXPLANATION OF ADMINISTRATION'S PLAN

Mr. SEIDMAN. If I could, with your permission, I will have my expert explain and then I will comment on it, if that is acceptable.

The CHAIRMAN. Fine.

Mr. SEIDMAN. Mr. Bovenzi, would you explain to the committee the charts?

The CHAIRMAN. Do you want to indicate your name and role before you start here?

Mr. BOVENZI. My name is John Bovenzi. I'm the deputy director of the Office of Research at the FDIC.

The CHAIRMAN. Very good.

Mr. BOVENZI. In the administration's financing proposal, bank premiums go directly to the FDIC bank insurance fund and aren't used for any other purpose.

Savings and loan premiums go to three different places. Initially, for the first 2 years, there would be some money going to the Resolution Trust Corporation to help pay for the principal in the REFCORP bonds. After that, roughly $1 billion a year or more would be going into the newly created Savings Association Insurance Fund that would also be under the FDIC. Some savings and loan premiums would also be going to the old FSLIC to help pay off FICO bonds and cover the costs for that.

Senator **Bryan**. Mr. Chairman, excuse me. Does the witness have a pointer that might be helpful?

The **Chairman**. I don't know that he does. Maybe we can give you something with which to point.

Mr. **Bovenzi**. The savings and loan premiums go to the new Savings Association Insurance Fund, to the old FSLIC, and to the Resolution Trust Corporation to help pay off the REFCORP principal.

The Federal Home Loan Banks would contribute some of their retained earnings and profits. Retained earnings would go toward some of the principal in REFCORP and also an annual income stream from the Federal Home Loan Banks would go to help pay off some of the interest on the REFCORP bonds. Also, the Federal Home Loan Banks would support the new Federal Home Loan Bank System.

All of this just says that the old receivership proceeds, anything received from liquidation of S&L's not accounted for over and above what was expected would help pay some of the cost for FSLIC and for the Resolution Trust Corporation. The new receivership proceeds over and above what's expected would help pay some of the interest on the REFCORP bonds.

Now Treasury is left here to pick up any shortfall in three different areas. They would pay for interest on the REFCORP bonds. They would pay for the costs of FSLIC that were not picked up by savings and loan premiums, and they would also be making a contribution to the new Savings Association Insurance Fund to help cover the cost of any savings and loans that may fail that are not already accounted for in the Resolution Trust Corporation.

So Treasury would be picking up some cost in three different areas.

Mr. **Seidman**. If I might, Mr. Chairman, I think the key when you look at this is that the industry is putting its money into these three funds through premiums and through the Federal Home Loan Banks. The Treasury is the backup. So every time you reduce anything that the industry is going to put in, then Treasury will have to pick up the difference. It's a balance between whatever you get from the industry and whatever is needed and the Treasury picks up the backup. That's why there are so many lines because it covers each of those.

The **Chairman**. Right. And it's fair to define the Treasury in a sense as the American people. I mean that is government as a whole which is all of us. So, if the Treasury has to fill in a large part of this, as it clearly will, that in effect has to come from the taxpayer base of the population as a whole.

Can you now give us a sense for the more simplified version and put that into perspective so that we're in a position then to perhaps ask some questions about both of these.

Mr. Bovenzi. Over here, the bank premiums in effect would be the same. They would just go directly to the FDIC bank insurance fund to help build up that fund. The savings and loan premiums would be based on the same premise. They would just go directly into the new Savings Association Insurance Fund.

Now if this were the case, any new failures that came along in the new Savings Association Insurance Fund for some period of time would have to move down here and be covered by Treasury which I'll explain in a minute. However, savings and loan premiums would be designed over some period of years just to help build up this new fund and not to cover additional failures that may occur.

The Treasury would directly cover REFCORP financing, both principal and interest, so that those would be direct costs, and Treasury would also contribute to old FSLIC to cover a large portion of the FICO bonds.

The Federal Home Loan Banks would contribute again their retained earnings and some portion of their profits both to old FSLIC and to financing the Federal Home Loan Bank System.

The Chairman. Now if I may—Senator Garn has been kind enough to say that this explanation is something that's sort of generic for our proceeding this morning, so I'm going to ask a couple questions about it before yielding to him.

I appreciate your explanation. It's a very complicated problem here but it's important to the question of how we finance the solution and how much that financing method will cost us and will cost taxpayers. In your professional judgment, Chairman Seidman, why isn't this a better route to go than the more complicated route? What do we gain or lose by going the far more complicated route here?

Mr. Seidman. Well, I have to say, Mr. Chairman, that I was not in on all the deliberations in that regard, so I'm not sure that I have all the information that I should to answer that question.

Clearly, under this method there will be less directly charged to the current budget than there would be if you just charged everything directly and did not use bonds and other things that go into setting up REFCORP.

So what the difference in the interest rate might be, I don't know. My judgment is that the rate difference should not be very large because the Treasury is absolutely on the line to make up the difference in all of these things. You would have to get somebody from the marketplace to tell you how many basis points higher the cost would be than it might be here. I really couldn't do that.

The Chairman. Beyond the question of not having the budget impact show up as large right away and also the fact that there is a certain financing premium—we actually have to pay a higher interest rate if we go the more indirect route that I think this chart illustrates—are there any other advantages or disadvantages of going with this degree of complexity?

Mr. Seidman. I'm not aware of any. There may be some, however, because I did not participate in that particular determination. So I think you would have to ask others about that.

The Chairman. One other question. In terms of total dollar cost, just total dollar cost, whether you take it in present dollars or whether you take it in absolute dollars added up over a 30-year timeframe, which is the more expensive plan here? Which plan costs more to implement?

Mr. SEIDMAN. Well, again, I haven't done any real work on that. I think that the plan which will require the highest interest rates to be paid will cost more. Usually there will be some premium to be paid for a plan that is not the direct obligation of the U.S. Treasury.

However, I must say that the plan does provide that the Treasury is absolutely committed on the backup. So I would not expect that difference to be large, although I would expect there would be one.

The CHAIRMAN. One final thing. Do you have any professional objection that you can cite to this alternative?

Mr. SEIDMAN. No, I have no objection. There is one preference and that is that all the premiums go to the insurer and then get distributed. Therefore, the insurer is in better control of its fate under that kind of a plan.

The CHAIRMAN. Thank you. Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

The CHAIRMAN. Excuse me, if I may, we have had two other members arrive and I just want to acknowledge their presence. Senator Kerry is here. Did you want to make an initial comment, Senator Kerry?

Senator KERRY. No, thank you, Mr. Chairman.

The CHAIRMAN. And Senator Pressler was here and had to step out but he will be back.

Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Chairman Seidman, during all of these discussions—not just during hearings but over a period of the last couple of years, and we've talked about this problem for much longer than that arguing about the size of it—there's been the impression that all of the regulatory structure of the Federal Home Loan Bank Board and FSLIC has been obviously wanting, has not done its job, and by comparison the FDIC has been a white knight and has done a remarkably good job. And I have no criticism of the FDIC. I think it's been well-run and the facts prove that over the years.

But the point that I wanted to make and ask you if you agreed with is that somehow the impression is that right up until the present time that FSLIC has not been doing its job and this is the reason that FDIC must rush in on the white horse and take over. But my background in this area indicates that there were a lot of dramatic changes made starting in 1985 when we diffused the regulatory authority back to each Federal Home Loan Bank district board. We took off the salary caps. We paid more money to get better examiners and beefed up the number of examiners so that they could do the job.

So I think it is clear that there was a great regulatory gap. The point I wanted to ask you about is whether suddenly now this has all changed, that there are or have been considerable changes made since 1985, and that FSLIC has been doing a much better job than some people would indicate. I'm talking about timeframes. I'm not going back. I can mount as much criticism as anybody else during certain periods of time. And also suggest that many of these mergers that have been so highly criticized were handled pretty well under the circumstances. In fact, as I look at your biggest deal, NCNB and so on in Texas, the way that that was handled—with not much capital—is not much different than many of the Southwest plan mergers.

What is your impression of those things?

FSLIC IS DOING A BETTER JOB

Mr. SEIDMAN. Well, first, Senator Garn, we have not really had any opportunity to review what FSLIC has done in the last 2 years in terms of actual first-hand knowledge because we have not been a part of their operation. But certainly we know from the many good people they have hired that they have a much better supervisory staff out there that is much improved over what it was a couple years ago. I think there's no question about that.

I can say from first-hand knowledge that the institutions that we have now gone into under the President's plan seem to be under control and that the Board has moved to stop the excesses and other things that were going on in a number of those institutions.

So my only first-hand knowledge is with the institutions we have been in. While we see some things that we think can be tightened up and so forth, we certainly have not found any kind of problem which would indicate that they have not been doing a reasonably good job.

Senator GARN. Well, again, the point I wish to make is that a lot of people don't seem to be aware that there were some regulatory changes way back in 1985 before the present Board was there, to upgrade and improve that regulatory situation rather dramatically compared to what it had been previous to that time.

Mr. SEIDMAN. I would agree with that statement. There's been a dramatic improvement.

Senator GARN. My understanding is that the legislative proposal would provide the FDIC with explicit authority concerning State powers given to State-chartered thrifts. You would have the authority to require that those powers now given to Federal thrifts would have to be put in separate subsidiaries or affiliates separately capitalized and whose capital cannot count toward capital requirements of the thrift itself.

The reason I bring this up is that both Chairman Riegle and I have been very concerned that the majority of the problem S&L's are State-chartered institutions allowed powers far beyond what Federal legislation allowed them and yet granted FDIC or FSLIC insurance, insuring those powers that we consider dangerous or going too far. And we get into the problem of State powers and the dual banking system and how do we handle that. That's why I bring up this understanding of you having the ability—you being the FDIC—to require a separate subsidiary. Also that means a thrift would have to set aside 100 percent capital to engage in these different activities, which is certainly a very tough new requirement. This is similar I believe, from my reading of it, to what we put in the Glass-Steagall bill last year—requiring separate subsidiaries or affiliates for powers that were more risky and so if a sale on an affiliate failed, it would not affect the ability of the thrift to meet its capital requirements or affect the insurance.

Is that your understanding of how we are proceeding in the authority granted to you to be able to do that?

Mr. SEIDMAN. I don't believe the bill specifically authorizes the use of subsidiaries. We believe it should, but I will check with my counsel.

Mr. DOUGLAS. It is implied, not specific. It is implied.

Mr. SEIDMAN. It is implied, but not specific. So I guess we would like to see it be specific. We think that it is very important that the Federal Government with the financial responsibility have the ability to determine what is going to be insured. That is not a violation, in our view, of States' rights. The States may authorize anything they want, but if the institution wants insurance, then it will have to meet Federal standards.

We believe the other things that the States authorize should be done in a separate subsidiary with the firewalls and other protections that you pointed out.

Senator GARN. Well, I agree, and that's why I asked the question. In several bills over the last few years we've talked about expanded powers for banks. We set up the legislation so that we could grant additional powers but so that the depositors' money would not be at risk. They would not have insurance on those additional powers and they would be separated, as you say, with so-called firewalls. So if it's an area we need to tighten up if it is only implied, I think we should tighten that area up.

Mr. SEIDMAN. We would agree with you on that and we think it is a vitally important issue because these entities may need to exercise some other powers to be economically viable. However, we don't want those powers to jeopardize the insurance funds. So that is an important issue.

Senator GARN. It is, and I also want to be able to handle it so that we don't stifle innovation in the States. We can look back to a lot of things that happened in State legislatures that Congress is not willing to do that have been helpful and proved safe and sound. So we need to if we can work on some explicit language that would give the insurers the ability to make those kinds of determinations—still allow states to experiment, but close off this real problem of Federal insurance for powers that are just too risky.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn. That's was a very important discussion I think.

Senator Graham of Florida has joined us. Senator Graham, did you have an opening comment you wanted to make?

Senator GRAHAM. I have no opening comment.

The CHAIRMAN. Thank you.

Senator Pressler, did you have an opening comment you wanted to make?

Senator PRESSLER. I have no opening statement. They are trying to get a quorum in Foreign Relations, so I apologize for being back and forth, Mr. Chairman.

The CHAIRMAN. We understand. A lot of members are in that same box today.

Senator Shelby.

Senator **Shelby**. Thank you, Mr. Chairman.

Mr. Seidman, the Bush proposal as I understand it would require that thrifts reach a 6-percent capital level by June 1, 1991. Will this cause an undue hardship on some so-called healthy thrifts and will a lot of them be unable to meet that deadline and should we give some flexibility there?

FLEXIBILITY ON 6 PERCENT CAPITAL LEVEL RULE

Mr. **Seidman**. First, the penalty for not meeting that requirement is simply that they can't grow. It does not require that they meet that.

Senator **Shelby**. It doesn't close them down.

Mr. **Seidman**. It does not close them down.

Senator **Shelby**. What do you mean by "can't grow?"

Mr. **Seidman**. It means that they can't increase their deposits until they get capital to a minimum standard.

Senator **Shelby**. Well, that puts them in never-never land, doesn't it?

Mr. **Seidman**. It does, and we have indicated in my longer written testimony that we think that the insurance agency should have the right to waive that rule under appropriate standards if we think it is for the good of the industry.

Senator **Shelby**. For example, let's suppose that a thrift in my State of Alabama, for example, since that's the ones I'm familiar with, let's say they are not up to 6 but they are growing steadily. They are running a good ship, so to speak. And if they were growing at ½ a point a year, ½ a percent, and well-supervised, should they be able to stay in business or should there be flexibility there?

Mr. **Seidman**. We believe the insurance agency should have the right to allow them to do that if they file a plan that shows that they are operating in a safe and sound manner and that they are growing at an appropriate rate and that this is improving their capital position. We've asked that there be some flexibility, although the basic standard I think will be good for most thrifts.

Senator **Shelby**. For most thrifts?

Mr. **Seidman**. Yes.

Senator **Shelby**. But if this is part of the proposal that we're talking about here contributes to the demise of a lot of thrifts by hard and fast rules, then you've got a problem there, right?

Mr. **Seidman**. Well, it shouldn't contribute to their demise because you are only saying that they can't grow. If they are undercapitalized, it generally is sound that they not grow until they bring their capital up.

Still, there are cases that are different and that's why we think there should be some flexibility.

Senator **Shelby**. Should we change the legislation in that regard to make sure you've got that flexibility?

Mr. **Seidman**. We believe appropriate flexibility given to the agency would be helpful in certain cases.

Senator **Shelby**. Let me get into the Resolution Trust Corporation. Assuming that this legislation is passed in appropriate form and we have what we call the Resolution Trust Corporation, that's going to be an agency with tremendous amounts of assets, billions and billions of dollars worth of assets, how are those assets going to be disposed of and who's going to supervise that? Will you do this?

Mr. SEIDMAN. That corporation is set up with a board of directors which sets policy.

Senator SHELBY. Will be set up, assuming the legislation?

Mr. SEIDMAN. It will be set up and the board of directors is provided for in the legislation—the Chairman of the Fed, the Secretary of the Treasury, and the Attorney General. The legislation provides for the FDIC to be hired by that corporation to manage those assets in accordance with the oversight of the board of directors.

Senator SHELBY. Do you now when you're dealing with FDIC assets do you at times auction off those assets and move them and get your money out of them? How do you do this? How do you move that?

Mr. SEIDMAN. Our basic policy is that every asset we have is for sale. It is for sale at current appraised values. We will not go much below the current appraised value to sell them. We will not dump them on the market by saying that we will take whatever anybody will offer on a given day. But we will sell any asset that we receive the appraised value for. We do not believe that we should be in the business of speculating in the value of assets and we do not believe that the private market is helped if large amounts of assets are held off the market under artificial conditions for long periods of time.

Senator SHELBY. Plus they waste away, too.

Mr. SEIDMAN. They waste away. They are not in the hands of those who must make them work and we believe that in the long run that will be very costly to the Government.

Senator SHELBY. Have you used any of the reputable auction houses in the country to dispose of some of your assets?

Mr. SEIDMAN. We have.

Senator SHELBY. Has that worked fairly well at times?

Mr. SEIDMAN. Yes. But we always have a reserve price. We do not sell them if they do not meet the reserve price.

Senator SHELBY. If they do not meet it and sometimes they go above it?

Mr. SEIDMAN. Occasionally, yes.

Senator SHELBY. Do you have more than one auction house doing this?

Mr. SEIDMAN. Yes. We've used several auction houses.

Senator SHELBY. How are they selected? Is this just an in-house selection?

Mr. SEIDMAN. They are selected based on their rates, on their merit, how successful they have been.

Senator SHELBY. On their reputation?

Mr. SEIDMAN. On their reputation, that's correct.

Senator SHELBY. And this will come later and we're a little premature on how this will work other than what you've outlined?

Mr. SEIDMAN. Well, to the extent that we've been in the business for a long time. You can look at what we've been doing and know that we will continue to follow that policy at the FDIC.

Senator SHELBY. But the asset disposition that we're talking about here will be some of the largest assets that's been known to anybody in this country as far as disposing of them by sale, auction or whatever?

Mr. SEIDMAN. I think it will be the largest that we have ever seen. That is correct.

Senator SHELBY. It will be like a new industry coming into the country.

Mr. SEIDMAN. Unfortunately.

Senator SHELBY. Mr. Chairman, thank you. My time has expired.

The CHAIRMAN. Thank you for those valuable questions, Senator Shelby.

Senator Heinz.

Senator HEINZ. Thank you very much, Mr. Chairman.

Mr. Seidman, there are going to be some very major differences between the powers of the FDIC over banks as opposed to thrifts. You will be given a very aggressive mandate for thrifts. You will have only a fraction of that for the banks.

Yet Mr. Clarke states in his testimony on pages 9 and 10 that banks and thrifts are becoming indistinguishable and that they should therefore be subject to the same regulatory standards.

In your testimony you state that, as the insurer of both banks and thrifts, you should have the same powers against both industries to prevent undue risk to the deposit insurance funds but apparently Mr. Clarke, who we will hear from later—I'm sorry this isn't a panel because we could have an interesting debate going—seems to disagree.

Now Senator Bond and others of my colleagues have roasted me for using foul metaphors from time to time, but I would like to ask, isn't sauce for the goose also sauce for the gander?

Mr. SEIDMAN. Well, I think the answer to your question is where you sit is where you stand. [Laughter.]

Therefore, in this case we took into consideration, even though our views were different, that the Comptroller's office has been in business for many, many years, and that there has been an arrangement that in general has worked well, although not always. In the spirit of compromise, and because Mr. Clarke is such a fine Comptroller, we simply didn't press that issue even though we thought it would be better if we had those powers.

Senator HEINZ. Are you asking Congress to give you those powers?

Mr. SEIDMAN. We are not. We made an agreement with the Comptroller that we wouldn't. I don't know why he's so—I guess he's afraid that you might do it anyway. But we are not asking for it because we agreed with the Comptroller we would not ask for it. Although, as you know from our study, we would have preferred it to come out that way.

Senator HEINZ. And if we give them to you you will not use them either? [Laughter.]

Mr. SEIDMAN. I assure you that if you give them to us we will use them.

Senator HEINZ. Well, we'll put you down as only giving half a disclaimer.

Mr. Seidman, in your testimony on pages 9 and 10 you urge us to delete those provisions of the President's proposal that would limit the FDIC's independence from the administration.

I understand in Mr. Clarke's testimony, by the way, on page 5, that the OCC has been under Treasury since Lincoln was President and still has managed to retain its independence.

You both agree independence is important. Why do you feel that the FDIC would lose its independence. The OCC, has no board, is a Treasury agency, is appointed by the President, and is subject to the Secretary of the Treasury who reports to the President. Why are you worried about the FDIC?

CONCERN ABOUT FDIC LOSING ITS INDEPENDENCE

Mr. SEIDMAN. I think the recent experience that we've seen with respect to the Bank Board where their independence was substantially under the control of OMB. Their budget to some extent, the number of personnel they could hire, the salaries they could pay—are some of the major reasons that we are up here talking about this subject.

Senator HEINZ. I understand what you're talking about. I think we all understand that history. But OCC has the same problem.

Mr. SEIDMAN. Well, the OCC doesn't have any money. There's a big difference. The OCC is not the one who picks up the bill if conservative standards are not put in place. My point has been that the insurer's life depends upon having a conservative system because they are the ones that pick up the bill. When they get out of control you have the same problem that you're now looking at with FSLIC. We hope to build into the system an institution whose basic reason for existing is to keep safe and sound the industry and the insurance fund which backs up the industry.

Senator HEINZ. I think that's a very responsive answer.

Now both of the witnesses—you and Mr. Clarke who will testify—have expressed doubt with respect to the need for a separate thrift industry and you both apparently agree that the market will ultimately decide whether one is needed.

Under the President's plan, however, if we enact it pretty much as is, we are making the decision that there will be a separate thrift industry. If the market decides we don't need a thrift industry and we have perpetuated one, the consequences of that would be financially profound to say the least because it means that that thrift industry, which you would be the insurer of, would shrink away to nothing and there would undoubtably be very large additional residual liabilities.

Is that a real risk?

Mr. SEIDMAN. I think it is a risk. I think it is a risk that can be controlled, Senator. In the first instance, there is a thrift industry now. So we only expressed doubt about whether you would create one if there were none now. But there is one now which we have to deal with and which has to have insured funds anyway. Our view is that it ought to be made a true thrift industry. That it ought not to try to be a bank in thrift's clothing. If it then appears that customers are not coming in the door, it can be handled by simply changing the rules and turning them into banks under appropriate rules.

Senator HEINZ. Mr. Seidman, thank you very much.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Bryan.

Senator **Bryan**. Thank you very much, Mr. Chairman.

Mr. Seidman, I'd like to express my personal appreciation as a member of the committee for the charts that you have prepared. The financing proposal to your left kind of reminds me of the labyrinth at Minos in mythology with all of the passageways and the turns and bends. This is clearly much simpler and easier I think for most people to understand.

My question relates to the testimony we've had from several preceding witnesses which have highlighted the role that the State-chartered savings and loans have played in creating this problem—the excessive powers, the abuse, that sort of thing.

I'd like to ask you a question which you touched upon I think lightly in your prepared testimony. As I understand the proposal that's before us, there would be the authority to in effect to revoke or withhold that insurance if indeed a insured savings and loan exceeded the standards that were deemed appropriate.

My concern is, how long would it take for that mechanism to take effect? You don't have 6 months, 1 year, 18 months, if things look like they're kind of getting out of control. My question specifically is, do you think that the legislation is specifically crafted in terms of the mechanics of getting that insurance withdrawn in a timely fashion before there is exposure on the part of the fund?

WITHDRAWAL OF INSURANCE

Mr. **Seidman**. I haven't really looked at that. The way the matter would go is that they would receive notice of whatever activity had to be removed from the institution. And, if the legislation is appropriately amended, they would have 3 months to put that activity into a subsidiary. If they didn't do that, then the insurance could be removed.

Since putting an activity into a subsidiary is normally not one that takes very long or is very difficult, I would think that the way the act is set up is workable.

Senator **Bryan**. I asked that question in the context, at least as I have been told, there was the authority under existing law to withhold insurance coverage but for some reason—whether there were political forces or economic uncertainty—that was simply not exercised in cases in which in retrospect it appears clear that it ought to have been.

Mr. **Seidman**. Well, we have been exercising that with state banks but it was not exercised with the Bank Board with respect to state S&L's.

Senator **Bryan**. Shifting the focus of the question, you've been a great advocate here this morning and on other occasions for maintaining the independent status of the FDIC and, as one member of the committee, I find that testimony and position persuasive.

My question now is a different aspect of the proposal that we have before us and that is the concept of wrapping the Federal Home Loan Bank System into the Treasury itself. A similar argument, as you know, has been made for the independence of that entity and the loss thereof if it's incorporated into the Treasury.

My question to you is, what would be your response to that?

Mr. **Seidman**. I am not as familiar with the need for that as I am with the FDIC's need for independence. I think there are arguments that can be made that the Bank Board and the banks are in effect financial institutions, creators of money and so forth, and that independence from the Treasury could be argued.

It might also be argued that they ought to be under HUD and under the housing authority since they are essentially there to aid housing.

So I think there are arguments on all sides of that. I think it is possible that you could remove the Bank Board and not remove the regulator. Then you would be in about the same position as you are with the Comptroller.

Senator **Bryan**. Finally, just one last question. In the past you've supported the concept of charging bank insurance premiums on overseas deposits since such deposits in effect in large institutions are de facto covered. We're not going to let an institution fail. I guess my question this morning is, as this proposal was being put together, did you make that argument and, if so, what were the arguments that countervailed so that that was not followed?

Mr. **Seidman**. There are a number of arguments in that area. Originally deposit insurance was only on insured deposits. Then that was changed so that the big banks would pay more because they are the ones that substantially have uninsured deposits. That has been somewhat changed by the fact now that in most large banks all depositors are protected.

So I think there are equitable arguments on both sides. Beyond that, our banks are competing in foreign markets. This would be an additional handicap to them and it might well jeopardize their position to compete. Finally, they can, if they want, put those deposits in foreign subsidiaries where it would be very difficult for us to reach them.

Looking at all those arguments on both sides, plus the practical difficulties of reaching the deposits and the likelihood that we would handicap our competitors out there in the world, the decision was made not to recommend that.

Senator **Bryan**. Is that your best judgment?

Mr. **Seidman**. At this time I think I would agree with the administration's judgment.

Senator **Bryan**. I see my time is up.

The **Chairman**. Thank you, Senator Bryan.

Senator Bond.

Senator **Bond**. Thank you, Mr. Chairman.

Mr. Seidman, we are delighted to have you here. I want to commend you specifically for your activities in setting up the fraud squad. I gained some notoriety as one who feels very strongly that effective and strong criminal enforcement against the perpetrators of fraud is a very important part of this whole question of resolving the thrift institution mess. I am particularly delighted in today's newspaper clipping, Mr. Chairman, to see the outcome of the *Renda* case in Kansas City where, in addition to securing a 2-year prison sentence, significant restitution was ordered. I hope that the example of the hanging judges in the Midwest will carry over in other areas and we commend you for pursuing both the criminal penalties and the restitution which in this instance and perhaps in other instances can be significant.

You suggest in your testimony that the thrift industry should not be permitted to engage in business incompatible with home finance. The committee has heard a great deal of testimony that the profitable thrifts today are the ones by and large who have stuck with their traditional business of mortgage lending.

The question that continues to bother some of us is, if we take away the additional powers that have been granted, how vulnerable do you think the industry would be to future interest rate volatility? I know we have the availability of adjustable rate mortgages. Consumers haven't always been wild about them. There are interest rate swaps and securitization. But if we restrict the thrifts to mortgage lending, can we be sure that a future interest rate spike will not put the industry lending long and borrowing short in the same kind of bottomless pit it found itself in in the early 1980's?

VULNERABILITY OF THE INDUSTRY TO FUTURE INTEREST RATE VOLATILITY

Mr. **SEIDMAN**. I think there will always be some interest rate risk in that industry. However, I believe proper supervision can manage it through the very things that you have indicated—through securitization, variable rate mortgages, and allowing the thrifts to do other activities in subsidiaries outside of the insured deposit institution so that they will have some ability economically to deal with other kinds of services that may be useful.

Let me point out that if it's in a subsidiary, real estate let's say, and it doesn't work, the insured institution is protected. But if it does work, the insured institution owns it so it gets the benefit of it. So I think that can be worked out in a way that will allow them to be economically viable. I think supervision can reasonably control interest rate risk in those institutions.

Senator **BOND**. I am interested in the magical number of 1.25 percent for the reserve level for insurance. What's the economic basis? How did you happen to come up with the nice round number of 1.25 percent?

Mr. **SEIDMAN**. Like any other number, it's a best estimate of what we think is a reasonable reserve looking at history. If you look at the FDIC and look at the premium that is now charged, .83 percent, if that premium had been charged all along and no rebates had been made, our fund would now have $26 billion more in it and would be well above that number. What that indicates to me is that a number in that area is certainly reasonable, perhaps not high enough, but certainly reasonable.

Senator **BOND**. Would you begin paying rebates again if it went past 1.25 percent?

Mr. **SEIDMAN**. I think that would depend on what the forecast for the fund indicated. I think that would be an important flexibility to the board to look at the forecast ahead and decide whether a rebate were appropriate.

Certainly in 1987, when we were looking at 1988 and the kinds of problems we were foreseeing in Texas, we wouldn't have paid a rebate no matter what the fund was at.

Senator **Bond**. One of the concerns that I've heard expressed by a number of people who have looked at the plans for resolving the problem is the possibility that the insurance premium in bad circumstances could go up to a maximum of 35 basis points. In initial discussions I got the sense from officials in Treasury, not in FDIC, that that was an area of premium level that was so high that it would make the industry uncompetitive. Several of the people who have talked about the prospects of selling these sick thrifts have said, "Look, if you have that potential administratively to go to 35 basis points, you're going to discourage some buyers."

Do you feel that that is too high? Do you feel that there is a danger if you got up to 35 basis points it would make the industry uncompetitive? As a final question, do you feel that the 3 basis point differential that is now built into the plan, is fair?

Mr. **Seidman**. Well, with respect to the higher rate, the insurer is after all the one that picks up the bill. If he charges somebody too much they become insolvent and he has to pick up the problem. So his basic purpose is going to be to charge rates which are reasonable but not ones that are going to destroy the viability of the industry. I think it would be very extraordinary to put it up to that rate except gradually. We would not object to some gradualization being put into the legislation if there were appropriate protection.

With respect to the difference in rates between the two industries, they are very small. The higher rate indicates the perhaps greater risk in the thrift industry because of interest rate gaps.

If you're going to rebate anyway, then the initial rate, a small difference like that, is not really very material.

Senator **Bond**. Thank you, Mr. Chairman.

The **Chairman**. Thank you very much, Senator Bond.

Senator Graham of Florida.

Senator **Graham**. Thank you, Mr. Chairman.

I'd like to pursue the questions that Senator Bond was asking relative to the insurance premium.

On page 21 you state that we concluded that FDIC deposit insurance premiums should be adjusted for the risk and cost incurred by the insurance fund.

From that, can we conclude that you would have been making this recommendation for an increase in FDIC insurance premium without regard to the circumstances of FSLIC?

Mr. **Seidman**. That is correct, Senator. We had a reduction of our fund of about $4 billion in 1988. We believe that would have called for higher premiums to rebuild the fund.

Senator **Graham**. Is this an ongoing process of FDIC evaluating its fund on some accrual standard to maintain the adequacy of the fund?

Mr. **Seidman**. That is correct. We think that this insurance should be cost-effective and self-financed. This will have a very useful effect on bankers and thrifts because they will know that if somebody is getting out of control in their industry they are going to have to pay for it and they won't be up here lobbying for less supervision.

Senator GRAHAM. In turning to the question that Senator Bryan was asking relative to the inclusion of foreign deposits as those against which the premiums would be assessed, is it your position that in the event of a failure that those deposits would be insured?

FOREIGN DEPOSITS

Mr. SEIDMAN. They are not insured. Whether or not they would be covered would depend upon whether we felt that not covering them and all the deposits might jeopardize the stability of the financial system or might cause the insurance fund a much larger loss. So we cannot say in every case that they would be covered by FDIC action. It would depend on the circumstances.

Senator GRAHAM. It's been represented that statements have been made to the effect that some of the banks which are most exposed in the sense that they hold the largest percentage of foreign deposits would be protected because it would be too damaging to the system should they fail.

Is that a statement that——

Mr. SEIDMAN. Yes, that is correct.

Senator GRAHAM. If that is correct, does your actuarial study as to the soundness of the FDIC fund incorporate the necessary resources to cover those foreign deposits?

Mr. SEIDMAN. We look at our experience and in our experience we have covered those in large institutions. So that is part of reviewing our experience to determine the appropriate levels, yes.

Senator GRAHAM. Does that therefore infer that part of the insurance premium which is being applied against the domestic deposits is going to cover the risk to the fund and the system from the foreign deposits which are not paying the insurance premium?

Mr. SEIDMAN. That is correct.

Senator GRAHAM. I'd like to next go to the question relative to the ability under current law of FDIC and FSLIC to deal with State-chartered institutions. I understand it's your position that FDIC currently has the power to set restrictions or other modifications on State-chartered banks if you conclude that the full exercise of those powers would be injurious to the fund?

Mr. SEIDMAN. That is correct.

Senator GRAHAM. What is the difference therefore between your capacity to do that and FSLIC's? Is it a statutory difference or an administrative determination as to whether to use the same or similar statutory powers?

Mr. SEIDMAN. I've heard some arguments about that. I am not an expert on it. All I know is that it was the opinion of the Board at one time that they would not exercise such powers. Whether they thought that was because they didn't have the legal right or they didn't think it was wise, I don't know.

Senator GRAHAM. Now that you have assumed many of the FSLIC responsibilities, do you have an opinion as to whether in your FSLIC capacity you have that statutory authority now?

Mr. SEIDMAN. We don't now because the only authority we have now is to take over a few of these as conservatorships and manage them. However, under the new proposed statute we would have those powers and we think they are absolutely essential to protect the insurance fund.

Senator GRAHAM. One of the issues that you had previously commented on was the question of the most appropriate location for the Home Loan Bank Board after all of this fallout hits the ground. You had indicated that you thought there were a number of places, including HUD, which might be the home for the Home Loan Bank Board.

Could you suggest what criteria you think the Congress should utilize in reaching a determination as to the most appropriate place? For instance, how much weight should be given to independence from political interference?

Mr. SEIDMAN. I think that's a key question on which the Congress is going to have to exercise judgment. That is whether or not they believe that because of the powers of this institution it ought to be independent. The administration has obviously thought that it could be operated under Treasury and operate appropriately. I think that that is a key question for Congress to consider, whether that board should be independent. If so, what kind of a board it should have, and what is its relationship to the industry, which is another key criteria which I think has to be looked at. I think the administration's view is it might be more independent under the Treasury than it has been in its present status.

Senator GRAHAM. I interpret their definition of independence as independence from the industry itself rather than independence from future political forces.

Mr. SEIDMAN. Exactly, and I think those things have to be weighed—independence from the administration against independence from the industry. I think that those are issues for Congress to consider. We do not have any objection to the solution the administration arrived at.

Senator GRAHAM. Thank you.

The CHAIRMAN. Thank you very much, Senator Graham.

Senator GARN. I just would clarify the question that you asked of the Chairman on the authority of FSLIC. You answered that you had it. There was a legal question on whether FSLIC had it and they took it to court and won. So it was settled in court. FSLIC did have that authority.

Mr. SEIDMAN. I didn't know that.

Senator GARN. But the reason they were not exercising it was there was a legal question and the court ruled that they did.

The CHAIRMAN. Let me cover two or three items in my next questioning period here.

First of all, with respect to the best estimates you've been able to do on what you might call the financing premium to go to what I call the indirect financing plan.

If you look at the cost over a 30-year period, which is the lifetime of the financing plan, the Treasury has said that the spread of the financing premium would be, in their estimate, 25 basis points. On the amount of the $50 billion borrowed, that represents $125 million a year and over 30 years just in terms of adding up the total dollars that's a figure of $3.75 billion.

We've gone to a number of people on Wall Street to ask them if the 25 basis point spread is really accurate and uniformly they say no, that despite the fact that there's a Government guaranty. However, because it's one-step removed, it kicks up the interest rate premium and they estimate generally that that premium would be more like 40 basis points.

If that were the case, the 40 basis points would yield an extra premium cost of $200 million a year for a total of $6 billion over the 30-year period.

So, one can make their own judgment between the $3.75 billion and the $6 billion as to what basis point estimate they want to use as a premium, but that is one element of the extra cost that's attached to the plan that's shown on this chart and obviously it's one of the questions that we're trying to decide about here on the committee.

Let me move to this question, Mr. Seidman. I have said a number of times that any powers allowed by a thrift institution that's covered by Federal deposit insurance should be spelled out by the Congress and not by the regulators. We should set the outer bounds. Regulators come and go. Sometimes you get the philosophy of letting anything happen and I think when you've got Federal deposit insurance that's not the way to make the decision.

I also think that if the thrifts are to retain their tax advantages and other advantages that their charter gives them, that their central focus should be on housing finance. It's presently 60 percent. I've suggested 70 percent. Some have suggested higher figures. But then you would wrap around that, at least in my mind, other kinds of community-based and consumer-related activities, consumer loans, family lending, education loans, credit cards, things of that kind. We could talk about the wrap-around activities that would take it, say, from 70 percent of housing up to 100 percent of the total authority.

Do you have any problem with that basic concept?

Mr. SEIDMAN. I have no problem with that, Mr. Chairman. As long as you allow them to do other kinds of economic activities in subsidiaries or affiliates which are appropriately screened so that if they fail they will not impinge on the insurance fund but will give them a chance for broader economic opportunities if it proves that the restrictions are fairly tight for the marketplace.

I fundamentally agree with what you have just stated.

The CHAIRMAN. So you would, in effect, then, shear off those State-granted activities. Your answer would be to put them in a separate affiliate with firewalls. You stressed that earlier, that the firewalls become very important. Is that right?

Mr. SEIDMAN. That is right. It must be very important and with very strong enforcement penalties.

The CHAIRMAN. And the firewalls I assume would prevent the leakage of capital which is needed over in the insured savings and loan to prevent the capital from leaking across into the affiliate.

Mr. SEIDMAN. That's correct. The capital in the subsidiary could not count as part of the thrift's capital. The thrift would have to be appropriately capitalized and it would have to have excess capital before it could put anything into the subsidiary.

The CHAIRMAN. And obviously very tough safeguards with respect to self-dealing.

Mr. SEIDMAN. Yes. You would have to treat that subsidiary either as just any other borrower, which they normally probably would have such relations with, or none at all for that matter.

The CHAIRMAN. Now in my opening statement I raised a concern about the independence of the proposed newly constituted FDIC Board. I want to recap now any concerns that you may have in this area. I've expressed my concerns. Are you concerned about the independence of that FDIC Board?

Mr. SEIDMAN. Well, I am concerned that since under the proposal two of the five members work for the administration directly, that there be independence among the other three members. Since those two cannot be chairman, I am concerned that the chairman have some independence and not be removable without cause by the administration.

The CHAIRMAN. Do you have any other specific suggestions? I take that to be a specific suggestion.

Mr. SEIDMAN. It is and we have the language here.

The CHAIRMAN. Are there others?

Mr. SEIDMAN. With respect to the composition of the board?

The CHAIRMAN. And the independence.

Mr. SEIDMAN. We don't have any other specific suggestions at this time. Just personally, it would be nice if the Board could continue with three people the way it has because I think it's an effective and efficient way to operate. That raises the question of what happens to the new chairman of the reserve system, but I think it's important—boy, I must have forgotten something.

The CHAIRMAN. You had two people that remembered at once.

Mr. SEIDMAN. I'm right. They're wrong. They have other things that they're worried about but we're just talking about the composition of the Board now. Is that correct?

The CHAIRMAN. And the independence of the Board, how the Board would function.

Mr. SEIDMAN. OK. Well, there are two other things that we have suggested. One is that the Board have the ability to incur debts up to its net worth—if you will read the legislation, there's a very complex formula in there which we read to limit us so that it is almost applicable at the present time based on our own resources. We think the important thing is that the institution not be able to incur obligations beyond its resources so that it can't obligate the taxpayer. Therefore the administration knows exactly how far they can go.

Then the third thing that we brought up is the reporting mechanism. We think it is important that we report. We think it is probably enough just to report to Treasury. To make it clear that in reporting we are not asking for approval and that we can report in the ordinary course of business. Otherwise, reporting can be made very onerous.

The CHAIRMAN. Very good. My time is up. Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Let me ask you the unanswerable question. What kind of bug or sticker do you recommend? You have the opportunity to do something no other witness has been able to do in the last 2 weeks. Tell us about the sticker.

TYPE OF STICKER TO BE USED

Mr. SEIDMAN. The sticker question is up for grabs. I have indicated that it seems to me inappropriate for two separate funds which have two separate resources to have the same sticker while they are in different financial positions. It seems to me that if you were registering a security with the SEC, they would not allow you to put the same sticker on two funds which are in entirely different financial positions. I think that as long as that is true, there ought to be some distinction between the two.

At some point down the line it may be appropriate to use one sticker when all the funds are appropriately capitalized. My own view is that the kind of thing that would be used would be something that says "FDIC Bank" or "FDIC Housing," however it may be designated.

I think there will be and ought to be a distinction between the two. On the other hand, if they are both administered by the FDIC, I think it is important that that be a part of the sticker. All of that at the present time is not very clear to us in the statute. There is some indication that both funds would have to use new names. One is BIF, which doesn't make me too happy.

Senator GARN. BIF and SAIV.

Mr. SEIDMAN. They say SAIV. I think it's SAIF. Maybe it means backed by foreign oil or something. But I am not really captivated by either of those names. I think more thought needs to go into that. I hope there will be some and we have stated so in our testimony.

Senator GARN. Well, I think you have at least given a better answer than most. The FDIC needs to be identified, but because you've got separate funds which the financing proposal indicates will be kept separate, those distinctions need to be made. So I think that's helpful.

Mr. SEIDMAN. That's our view and we would be pleased to work with you on that if you so desire.

Senator GARN. I personally am not in the business of designing bugs.

I appreciate your answer to one of my colleagues, either Senator Graham or Senator Bryan, about the issue of the bank premiums. I've tried very hard, particularly in talking to bankers and answering their questions about why their premiums were going to be increased, to point out that it had nothing to do with the FSLIC problem, that the funds would be absolutely kept separate, and if there were absolutely no thrift crisis at all there would be a necessity for increasing bank premiums. So I appreciate your response to that issue because I think it's been largely obscured in all of the debate, that there was a $4.3 billion loss last year, the biggest in FDIC's history, without including the bank problem in Texas.

Mr. SEIDMAN. It does include that, Senator.

Senator GARN. When you testified last August, you were anticipating a rather large drop in the fund. To isolate away from the FSLIC problem for a moment, do you feel in your projections for 1989 that the bank premium increase will be sufficient? What is your projection for 1989 for the FDIC?

Mr. SEIDMAN. Currently we are projecting something near break-even for 1989. Given what we see on the horizon now, we believe that we will break even or do a little better. Of course, things could happen to change that, but our best estimate now is that we will break even.

Senator GARN. With the increased premium?

Mr. SEIDMAN. With the increased premium, we may have a small margin. There is no increase in 1989. It is for 1990 that it comes in.

Senator GARN. So you are projecting break even at the current premium rate in 1989?

Mr. SEIDMAN. That is correct.

Senator GARN. I am also concerned about the zeal to put thrifts under bank accounting practices with no deviations.

Now obviously in light of what has taken place I don't want special treatment or looser accounting standards for thrifts than for banks, but there are some characteristics of savings and loans or thrifts that require regulations that are tailored to thrifts—at least some of the traditional ones. An example is mortgage loans. The Bank Board recently proposed a tough risk-based capital standard that takes into account interest rate risk which the bank regulation does not do. So there's an example of a deviation that makes it tougher than on banks.

So would you agree that rather than just abiding by the general principle that we ought to treat savings and loans like banks and should have the same regulations for both, that because of the different character of thrifts there ought to be some deviations allowed, and in cases like the example I've used, a tougher deviation than there is on banks?

Mr. SEIDMAN. I would certainly support the fact that the bank regulation would be the minimum standard and that it could be increased for thrifts if it appeared appropriate.

Senator GARN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Mr. Seidman, I listened with interest to your exchange with Chairman Riegle about the firewalls and allowing, I take it, a State-chartered institution to engage in activities beyond those permitted to federally chartered institutions.

Do you think the insurer should have the authority to require State-chartered thrifts not to engage in a risky activity in order to retain Federal deposit insurance? I'm going further out now beyond your firewall.

Mr. SEIDMAN. You mean not to do something in the subsidiary of the thrift that the State allows?

Senator SARBANES. That's right.

Mr. SEIDMAN. Yes, I think the insurer should have that power.

Senator SARBANES. OK. Now how much danger do you think there is that—are you going to limit the name that the separated affiliate can use or could it use the name of the insured institution?

Mr. SEIDMAN. I think it would be able to use the name. However, there would be appropriate legal requirements so that you could not look through the thrift to get at the subsidiary. We drafted some language like that for previous Congresses which we would be happy to present to you.

Senator **Sarbanes**. Well, your theory is that if the affiliate runs into a lot of trouble that's tough and they have to just take the consequences of that, that you in effect shielded the insured institution by your firewalls. But what about the notion that in the public view you're not going to be able to make that distinction and if the affiliate runs into trouble that that trouble is going to spill back to the insured institution. All of a sudden you're going to be confronted with a problem in the insured institution whose deposits you've covered, the Government has covered, and all of a sudden we're going to be incurring important financial liabilities.

Mr. **Seidman**. I don't think that that will be the case, Senator. It might be, that in the worst case the public would think that their insured deposits were somehow jeopardized because a subsidiary had failed. If they did, they would take out their deposits but the institution is solvent and therefore those deposits could be replaced by more sophisticated depositors. I think that the key is that the institution itself is solvent and is not going to be hurt by the total loss of the subsidiary.

In today's world, we have banks and holding companies. One fails and the other doesn't and the depositors don't run to the other one and take out their money. I think depositors are quite sophisticated about those things these days.

But even if they weren't, it is a liquidity problem which can be handled. It is a short-term problem. It is not a basic problem that should cost the insurance fund anything.

Senator **Sarbanes**. What are the benefits that are gained by allowing the States to allow State-chartered institutions to engage in activities beyond those of federally chartered and still get the Federal deposit insurance?

Mr. **Seidman**. Well, the advantage—and I think this might also be considered at the Federal level—is that we live in a real economic world where competition decides your true viability. There may be many services in subsidiaries that we don't want to insure but are necessary for an overall viable activity.

That's certainly true in banks. The whole thing of powers and all the issues that were discussed last year are part of that. What we are trying to do is make sure that our financial institutions overall are economically viable in the marketplace, that they can compete, and at the same time protect the part that's financed by insured deposits.

I think it would be very sad if this Congress sharply limited financial institutions and what they could do because of deposit insurance and didn't allow them to have economic activities not covered by deposit insurance which will make them economically viable. That may be more dangerous for the system than almost anything else we could do.

Senator **Sarbanes**. Well, wasn't a lot of the difficulty that we've now encountered the consequence of institutions which had deposit insurance on the other hand being able to engage in the most speculative activities on the other side?

Mr. **Seidman**. The problem was that those activities were carried on in the thrift where insured funds could be used. That's exactly the thing that the chairman has suggested we ought not to allow and we agree with that.

Senator SARBANES. And you're going to try to prevent it now by putting in the firewall?

Mr. SEIDMAN. We believe we can successfully do that. We use firewalls in many things already in supervision.

Senator SARBANES. At what point will the firewall come into play with respect to the powers?

Mr. SEIDMAN. Well, the firewall would simply say that if the State authorizes an activity which is not authorized for the thrift, then it would be put into a subsidiary. At that point that capital would have to be excess capital and that institution would be screened off from doing business with the thrift.

Senator SARBANES. So any power authorized by a State beyond the powers authorized to a federally chartered S&L must go into the subsidiary and be on the other side of the firewall. Is that correct?

Mr. SEIDMAN. That's correct.

Senator SARBANES. You would allow no room to an extra power within the insured deposit institution, is that correct?

Mr. SEIDMAN. Well, that depends on exactly how Congress defines what can be inside and in banks. That's not too easy to do, but in thrifts it's much easier if you follow the thriftiness test sufficiently.

The only discretion of the insurer would be to deal with whatever definitions have been put before them.

Senator SARBANES. Could I ask one final question, Mr. Chairman?

The CHAIRMAN. Yes.

Senator SARBANES. I know you're going with a 6 percent capital ratio. Is that your standard?

Mr. SEIDMAN. Yes.

Senator SARBANES. I know many see that as onerous in the current circumstance, but let me ask you a more hypothetical question.

If you weren't dealing in the situation in which you are, in which you have a lot of institutions well short of that and you want to bring them up to that standard, and they're all saying, well, how are we going to reach that standard—but in a more ideal world, do you think 6 percent is adequate?

Let me put the question another way. How can we build up a bigger margin as a means of protection before you reach the deposit insurance if an institution gets into trouble?

Mr. SEIDMAN. The ideal level of capital is a very difficult question. I recall that when Chairman Greenspan came here his first assignment was to use his great statistics at the Fed, where they have unlimited resources, to determine scientifically how that was done. I haven't seen the results yet. I think it is very difficult to use anything but experience. There is a limit on how much capital you can require before you make the institutions economically not viable because they cannot earn returns which will allow them to raise capital. So in a way, you have to deal with the protection of the fund balanced by the viability of the institution in the capital markets.

Senator **Sarbanes**. You don't regard 6 percent as being anywhere near that limit, do you?

Mr. **Seidman**. I think 6 percent has been accepted. I think overall, if you look at the losses that the FDIC has had, particularly in Texas, it's hard to know what level of capital you would have had to have to protect against that. In other words, usually when these losses come up capital helps reduce them. But, the institution goes because the loss is so much in excess of the capital.

Senator **Sarbanes**. I see my time is up.

The **Chairman**. Would you be willing to prepare at the request of the committee or at the request of the chairman a response that would indicate if you take housing as the centerpiece, the mortgage-lending function that's been the tradition of the savings and loan industry. If you assume that's 70 percent, would you be willing to take an independent look as to what the wraparound activities might be that could go within a national charter that answers this question as to what's inside a 50-State national charter, the related activities, and give us your thinking on that? I will ask others as well, but would you do that?

Mr. **Seidman**. Well, we will certainly prepare what we believe might be at least a starting point for the discussion.

The **Chairman**. I would appreciate that. That would be very helpful.

Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman.

I would like to ask questions in two areas. First, to follow upon the questions that you've been pursuing relative to the financing proposals which are outlined in these two charts, the chairman has indicated that there's a range of estimates as to what the additional cost will be of the administration's financing proposal, but it's someplace from 25 basis points up.

What is the justification for a financing plan which is other than the least cost in aggregate plan?

Mr. **Seidman**. Again, I was not a part of designing the plan so I may not have all the background, However, I think budgetary considerations were an important factor, plus trying to tie in the cost so the industry would pay its appropriate share. But again, I may not be the right one to answer that question.

Senator **Graham**. To me, we have an ethical issue here in the sense that our generation, or at least the last 10 years of our generation, has been essentially responsible for this problem. We are now solving it by a long-term 30-year financing proposal so that our children and grandchildren can pay for it. It seems to me that at the least we ought to ask them to pay no more than is necessary and I can't come to a very satisfactory answer that justifies why we should accept any other than the least cost.

With that additional editorial comment, do you have anything else to say?

Mr. **Seidman**. I don't think I have much to add to what I said, Senator.

Senator **Graham**. Let me turn then to the question of the depositor's responsibility. I am concerned—this is an advertisement which is running now in some Florida newspapers which has the encouraging headline, "Hot Rate! Short-term $1,000 Minimum," and then advertises 6 month certificates at an annual yield of 9.56 percent. This is an institution which is the recent child of Federal regulatory action by putting together a number of failed institutions into a newly reconstituted S&L that is now paying rates that are from ½ a point to 1½ points above what other FSLIC insured institutions in the same Tampa Bay region of Florida are paying.

My questions are: Since you're going to be dealing now with a number of these kinds of institutions, do you think there should be any constraints placed on the products of regulatory reincarnation as to what they can pay in the marketplace in order to secure funds?

Mr. SEIDMAN. I think there should be. We try to exercise that with banks. We're not always successful. I think that further illustrates the problem of having federally supported institutions continue in the marketplace. Our preference always, although we are not always able to do that, is to have the institution take whatever subsidy we have to provide to pay for the loss. Then have the institution go off as an independent institution in which we have little or no financial interest.

I think the more we create government-aided institutions to continue in the marketplace over the long run, the more you're going to see of those kinds of problems. I think they can be very difficult for the industry. That's why I think it is so important—as I answered some other questions—to try to get the assets and the institutions back into the private sector and out of the Government's hands.

Senator GRAHAM. Well, this institution I believe is now in private hands having recently been reconstituted by FSLIC, but their need for liquidity has been such that they are now paying these carnivorous rates—carnivorous in that they are chewing up the other institutions, particularly those that are marginal, and making it more likely that we will have some more cadavers.

Mr. SEIDMAN. Well, I don't know whether those institutions have income maintenance contracts and other things that give them an economic advantage. That could be one factor in the case.

Also, of course, rates are going up. You're going to see all of these institutions moving their rates up because there is going to be disintermediation unless they do. They may be just leading somewhat and this could be what you're going to see all across the board.

SHOULD BROKERED DEPOSITS BE RESTRICTED?

Senator GRAHAM. One of the things that this kind of rate competition has done is create a market for the brokered deposits and the magnet to attract them. Apparently, some time in the early to mid 1980's there were some suggestions to restrict brokered deposits.

Do you believe that we ought to dust off those ideas and look at them again?

Mr. SEIDMAN. We think that is a problem that needs to be controlled. We don't think trying to control it through the broker is a particularly sound way to do it. First, it is pretty easy for institutions to set up their own desks and in effect avoid brokering.

Second, the kinds of remedies that were suggested were after the fact.

What we are going to propose very shortly for banks is a regulation that will require any institution that is going to grow through brokered deposits to notify us ahead of time and indicate why they are using these deposits to grow. We will have a chance to review their plans and if we think they are unsafe and unsound, step in before they actually get the brokered deposits. We will be proposing a regulation in that area very shortly.

Senator GRAHAM. And you believe you have the statutory authority to take that action?

Mr. SEIDMAN. We do.

Senator GRAHAM. Do you believe that FSLIC has the statutory authority to take that action?

Mr. SEIDMAN. I really don't know.

Senator GRAHAM. Would the plan that the administration proposed clearly give them that authority?

Mr. SEIDMAN. I believe it would, yes.

Senator GRAHAM. Mr. Chairman, if I could ask one last question?

The CHAIRMAN. Please do.

Senator GRAHAM. I am concerned about the fact that we now are operating in essentially a marketplace-driven, deregulated environment whose discipline is the risk factor. And yet, as it relates to the depositor, at least up to $100,000, we have removed any risk. For that reason, frankly, people would fail an I.Q. test if they didn't take their money out of institutions that are paying a marketplace rate and put them into Beach Federal and others that are paying these excessive rates.

DEPOSITOR RESPONSIBILITY

Do you have any thoughts as to whether the system should provide for some discipline on depositors so that they had some sense of responsibility for their actions?

Mr. SEIDMAN. We addressed that question in detail in our study, Senator, and we looked for ways that we thought might be practical to do that. We immediately ran into the problem that we have been—because of the effect on the financial system—rescuing very large banks in terms of all depositors. Once you do that, it doesn't seem fair to have a different standard to the extent possible for small banks.

Then we examined whether depositors are really very good disciplinarians or not. After all, the Federal Reserve and the FDIC were both created because depositors get out of hand at certain periods and, frankly, whether depositors should be able to tell the condition of any given bank on any given day in order to exercise that discipline, I think may be asking more of them than they can really provide.

We have 2,000 examiners out there and we don't know the condition of every bank on any given day. The banking system is different because it really has to be used to a considerable extent by people and I think the American people ought to have a safe harbor and therefore it becomes much more important that our supervision is adequate because it has to replace that discipline.

Senator GRAHAM. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Graham.

We're going to just move quickly through a final round because Comptroller Clarke has asked to testify and we need to leave some time for that. In addition, we have both party caucuses meeting at the lunch period today on very important other matters.

I want to cover a couple of things quickly and then I'm going to yield to Senator Garn.

I have suggested previously that we consider a fresh name for what in effect I think is going to be a redefined and substantially restructured business in the savings and loan area. We're going to change the insurance system. We're going to change the structure around it. We're going to do some definitional work, I think it's fair to say in terms of what constitutes the business, the charter of the business for the future. And the more I thought about it a name on the order of a Federal housing bank, Federal implying that it's uniform State to State and not something different in every different place, and the fact that the housing function is the centerpiece—I've suggested 70 percent and some in the House have talked about 80 percent—and the fact that we want to also establish some restoration of confidence in the institution. That's one of the reasons we're changing the insurance system and so forth to give people the view that their money is safe and that we are in some important sense making a fresh start.

Does some nomenclature like that—a Federal housing bank—sound sensible to you? I'm not asking you to take an official position. I'm just asking you as a professional to think about it. We're in the middle of this problem. Is something along that line perhaps worth thinking about here?

Mr. SEIDMAN. I think it is worth thinking about. I guess I hesitate because there are millions of people out there that recognize savings and loan as a place they go to get mortgages. I would want to make sure that we didn't lose the good side of the label in changing the label. That might be something that would need to be studied. I think the name would be more appropriate really for the institution.

The CHAIRMAN. Now can you tell us why it is that the State of Texas, where what I consider to be the lax State power rules backed up by Federal deposit insurance, is the single biggest source of the losses that we've seen in the system. In 1987, the last year for which we have data, in terms of the full dollar loss in the savings and loan system across the country, 52 percent of the loss occurred in two States—Texas and California, with the most wide open State powers backed up by Federal deposit insurance.

I want to fix that. I think a number of my colleagues have made it clear they do as well.

But if you take within the State of Texas, why is it that the thrift industry there would have experienced a systems failure that's at least four times the magnitude of the failures in the banking system? Now you've had some big failures there too, but you've got many more deposits in the banking system there.

TEXAS S&L'S HAD A MUCH HIGHER RATE OF LOSS

What was there about the savings and loan system rules and circumstance in Texas that would have caused a much higher rate of loss in that set of financial institutions than we have seen in the parallel banking institutions area?

Mr. SEIDMAN. I believe the first reason is that there simply wasn't adequate supervision. That the lack of supervision was so great that there was a great deal more fraud and insider abuse. The lack of regular supervision, plus supervision against fraud and insider abuse, it seems to me both of those things were very important.

Third, of course, the S&L's were in the land and building business. That is where the Texas economy has been hit the hardest. They had concentrations in the worst part of the economic problems in Texas.

I think the combination of those things resulted in the kind of difference in losses, although I must say we are not very proud of our losses. There seems to me that there are some things we can do to improve there, too.

The CHAIRMAN. Senator Garn.

Senator GARN. Mr. Chairman, I would put the rest of my questions in writing. The Comptroller may not get to testify very long.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Mr. Chairman, I have no more questions. I do want to thank you for coming here today and I look forward to what we do legislatively with all this. If we're able to do it in some degree and do it as quickly as possible, it will be a miracle here in the Congress, as you know, Mr. Seidman.

Mr. SEIDMAN. Yes.

The CHAIRMAN. Well, we intend to craft a miracle. That's our responsibility.

Senator SHELBY. If the chairman would yield, I think the chairman is speaking for all of us. We have to.

The CHAIRMAN. And we fully intend to. We have to and we intend to deliver on that requirement.

Senator Graham.

Senator GRAHAM. Mr. Chairman, I have no further questions. I would like to thank Mr. Seidman for his comments today, which as in the past have been very helpful.

I prophesize that when the Hall of Fame of the last few years on financial industry regulation is constructed, there are going to be a lot of vacant walls, but that one of those walls will be filled with Mr. Seidman's portrait.

Mr. SEIDMAN. Thank you.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Mr. Chairman, I just have one question.

I'm not clear, Mr. Seidman, from your response to Senator Garn exactly what this bug would look like that would appear on the door of these institutions.

Mr. SEIDMAN. That's because I am not clear either, Senator, at this point. I was simply trying to put out an outline of what it might possibly be. As I indicated, I think further work is necessary in that area.

Senator SARBANES. Would you have the same bug available to both the banking and the S&L institutions?

Mr. SEIDMAN. Not at this time. I think their funds are so different that it would be misleading and inappropriate. I think at some time it might be appropriate, but for the foreseeable future I think the bugs will be different, although they might well indicate that the FDIC is administering both funds.

Senator SARBANES. Why do you think it should indicate that, if the funds are separate, which is after all the financial wherewithal to back the deposits?

Mr. SEIDMAN. Well, I don't think it is a requirement. It seems to me that it is full disclosure.

Senator SARBANES. Do you think those bugs are important to an institution in attracting funds and in the competition with other institutions to attract funds?

Mr. SEIDMAN. I think they are very important. I think the banks have worked long and hard to maintain theirs. I think nothing should be done that jeopardizes the good will they have in their logo.

Senator SARBANES. Thank you very much.

The CHAIRMAN. I wonder if the answer might not be that with a seal on the window we're backing up all these deposits. We've said it a hundred times. The President has said it repeatedly, that everybody's deposits are safe up to the insurance limits. And I'm wondering if maybe we don't need to have a new symbol or seal that goes on the door in addition to these other two, that somehow it really makes it very explicit that that is the case.

There is not much sense in people thinking that there's some material difference about the safety of their deposits when in fact we are standing behind both sets of deposits in an equal fashion.

Mr. SEIDMAN. Well, I agree with that. However, we are trying to make these funds self-funding so that we won't have to go through this again. Therefore, being self-funding, if there are more failures on one side or the other, it is going to increase the cost of those kinds of institutions. There is an economic factor in having separate funds which I think has to be considered. Therefore, I think it might be inappropriate—we could have a logo saying Congress and the President all say your funds are safe, but I really think the funds themselves ought to have a distinction.

The CHAIRMAN. Well, I don't disagree with that, but I want to make this point. That is, we want this reform package to work and the degree to which it works depends upon how well designed it is and how straightforward and well thought out it is, but also the public belief and confidence in the solution.

So I would like to see us do this job well enough so that when the sticker goes on the window, whether it's the same or separate, everybody is clear on the fact that their money is safe there.

If we don't get that job done, if we leave some lingering impression that somehow we've got a defective industry out there or some place that people can't feel confident about, we cut against the very purpose of our effort to craft a solution. We have to have a solution that not only works but restores confidence.

So I think it's not a small issue. I don't aim this at you, but I'm just saying generally, we have got to understand that not only do we have to have a reform package that really meets the toughest sort of scrutiny as to whether or not it's sound and is going to work in the future, but I think there has to be coming out of that to the public the belief that their money is absolutely as safe in one institution with one name on the door that's federally insured as it is in another institution down the street federally insured with a different name under it. If we don't get that done, then I think we are going to make it very difficult for the savings and loan industry to have the kind of long positive future that Secretary Brady came in here and talked about.

Mr. SEIDMAN. Well, I agree with that. That is why I suggested possibly using the FDIC, which so far the public seems to have full confidence in, and simply designating with the FDIC which fund it is in for full disclosure.

Senator SHELBY. Mr. Chairman?

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Mr. Chairman, I want to follow up on the theme you are touching on.

I know the seal is important because that is an outward manifestation of what the strength of FDIC is, and the people have stood behind that. But we have had an erosion of confidence there. As we all know, you have got an outflow of money from the savings and loan.

How do we stop that from—maybe it is a trickle now, maybe a little more, but it could hemorrhage, and that would just unwind this whole plan—other than seal, which is demonstrative, what could we best do to reassure the average depositor in America, Mr. Seidman, that the thrifts are going to be safe?

And I think that is very important.

Mr. SEIDMAN. Well, of course if Congress wanted to, you could directly put the full faith and credit of the Government behind the insurance funds. The problem with doing that is that you to some extent move away from trying to have these industries self-finance their insurance.

Senator SHELBY. OK. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Shelby.

We may have some additional questions for the record. I know some of my colleagues that had to be in the Armed Services Committee and the Budget Committee will have questions for you, but we thank you very much for your work and for your testimony today. It is very important to us.

Mr. SEIDMAN. Thank you.

The CHAIRMAN. Thank you.

As Chairman Seidman and his people leave the room, let us pause just for a minute while Comptroller of the Currency Clarke comes forward.

Let me ask others in the room to find seats so we can have order in the committee room.

Mr. Clarke, you have requested to testify today, and we are honoring your request by having you appear at this time.

We will make your full statement a part of the record. I would ask you, if you could, to summarize the key points you want to make in, say, a 10-minute period of time, and then let's leave the balance for the questions that I know my colleagues and I will have.

STATEMENT OF ROBERT L. CLARKE, COMPTROLLER OF THE CURRENCY

Mr. CLARKE. Thank you, Mr. Chairman.

I would say at the outset I certainly didn't mean to inflict myself on the committee, but we are dealing with a very important issue that has a lot of ramifications for commercial banks as well as for the savings and loan industry and for the regulatory structure, of which the Office of the Comptroller of the Currency is certainly a part. So I appreciate having the opportunity to be here, and since this is the first time I have appeared before the committee since you became Chairman, congratulations.

The CHAIRMAN. Thank you.

Mr. CLARKE. And sympathies, because you have a large responsibility at this particular time.

The CHAIRMAN. Well, I have a lot of good helpers up here, and that makes a difference.

Mr. CLARKE. I want to limit my discussion this morning to two very crucial changes that the administration's plan would bring about. And, I do so because the Comptroller of the Currency, regardless of who holds that office, has a unique job that promotes a practical understanding of depository institution supervision in general and of why those two changes are so urgently needed in particular.

The Office of the Comptroller of the Currency, as you know, is the primary supervisor of federally chartered banks. We supervise approximately 4,300 national banks, and these banks hold over 60 percent of the assets of the commercial bank industry.

Our job is to ensure the safety and soundness of the national banking system that these institutions together make up. We grant these banks their charters to do business. We examine them to ascertain their financial condition. If need be, we declare them insolvent and revoke their charters. But we do not insure them. That is the job of the Federal Deposit Insurance Corporation. Once the OCC or a State bank supervisor declares a bank insolvent, it is the FDIC's job to find a merger partner or other acquirer or to liquidate, while at the same time insuring the depositors against loss.

The Comptroller of the Currency is one of the three members of the FDIC Board of Directors. Other than that connection, the two agencies, the OCC and the FDIC, are completely independent from each other. We work together in harmony, but the responsibilities of the two agencies are different.

Furthermore, the OCC is an agency within the Department of the Treasury, but it is an agency with a difference. At our creation in 1863, Congress formally recognized our operating independence from Treasury, and Congress has thereafter reaffirmed it.

I have gone into such detail on these fundamental technical aspects of the OCC's organization because they are all important to understanding the two crucial changes that I mentioned at the beginning.

By contrast with the situation in banking, the same agency that supervises thrifts today also insures their deposits, and that situation, I believe, should not continue. The first crucial change which the President's plan would bring about is to create a healthy separation between the primary supervision of the thrift industry and the insuring of the industry's deposits. The administration envisions accomplishing this separation by moving the insurance of the thrift industry to the FDIC and moving the supervision to a newly created agency within the Treasury, much like the OCC.

Furthermore, as you know, Mr. Chairman, thrift supervisors have operated under a statutory mandate to promote the home finance lending that they are charged with supervising, a role that no bank supervisor has or ever has had. The second crucial change which the administration would bring about is to make sure that support for housing finance is consistent with safety and soundness.

Both changes, Mr. Chairman, are aimed at separating the conflicting interests that have tugged at each other in the supervision of the thrift industry. Conflicting interests, we believe, have substantially weakened the supervision of thrifts in the past. We believe that supervision of thrifts would be strengthened in the future if those conflicting interests are separated by assigning them to different agencies. And, in doing so, the most dramatic change would be the first, the separation of the roles of deposit insurer and supervisor.

Under the administration's proposal, the Federal Home Loan Bank System would be established as an agency within the Department of the Treasury and would be headed by one person. The Federal Home Loan Bank System would have primary responsibility for the day-to-day supervision of Federal thrift institutions and would be the principal Federal supervisor of State-chartered thrifts. Under the Department of the Treasury, the Federal Home Loan Bank System would have the same degree of independence the OCC has had since 1863. Secretary Brady reaffirmed the need for independence for bank and thrift supervisors when he testified to this committee last week that the Treasury Department would not micromanage the Federal Home Loan Bank System.

As I stated before, the administration's plan would transfer the function of insuring thrift deposits to the FDIC. The FDIC would exercise enforcement powers that are directly related to the provision of deposit insurance, most notably, the power to revoke deposit insurance.

This division of responsibility is critical to the achievement of an important policy objective. This is the issue that Senator Heinz raised earlier this morning. It ensures that the safety of the insurance fund will be balanced against the need for competition and innovation in the market for financial services which, like all businesses, necessarily entails some risk.

A deposit insurer's most immediate and obvious objective, like the objective of any other insurer, is, and must be, to preserve the insurance fund. An insurer naturally tends to view banking activities predominantly in terms of the threat they may pose to the insurance fund, rather than in terms of the value they may provide to bank customers. Consequently, an insurer can be expected, as long as it is solvent, to take an aggressively conservative approach to bank supervision. Promising, but unproven, developments are likely to be resisted because of their uncertain effects on the volume of insurance claims. Now, I might add that this is less likely when the insurer is under the leadership of my good friend Bill Seidman, who is, as every member of this committee knows, a fellow supporter of increased competitive opportunities for banks. But it is important to remember that you are legislating for a long time to come and you are creating a structure that we hope will continue through the tenure of many FDIC chairmen.

In contrast to an insurer, a bank supervisor's principal objective is to foster the existence of a financial services delivery system that provides the services that will satisfy the needs of customers while maintaining the health and the stability of that system. The supervisor's view is that bank failures are not always a signal that the system is in trouble, but may simply be a natural consequence of the operation of a private market in which some enterprises succeed and some do not. The supervisor, therefore, is more likely than the insurer to be receptive to measures that will increase competition and to look favorably upon innovations that would enable banks to adapt to changing demands for financial services.

Each approach is appropriate for the role it is assigned. In each case, there should be an appropriate review, with the insurer looking at the situation from the insurer's vantage point and the supervisor doing so from the supervisor's perspective. A single agency, we believe, cannot do both at the same time. The system benefits if there is a healthy tension, and a healthy tension can only exist if there are two sides that pull against each other.

Now, I don't want to give the impression that bank supervisors ignore the risks that are taken by insured institutions or that we are unconcerned with the adequacy or safety of the insurance fund. Recent actions on the part of the OCC that are discussed in my written statement illustrate why this is not the case. But insurers and supervisors have differing responsibilities, and the chances of these responsibilities balancing each other are vastly improved when insurance and supervision are separated in different agencies.

For reasons I have discussed, I disagree with the recommendation of the FDIC staff report on deposit insurance reform which would change current practice and give the insurer broad regulatory and supervisory powers over national banks and State-chartered Federal Reserve member banks. As you have heard Chairman Seidman state this morning, the FDIC is not asking the Congress for that authority. As the administration's proposals provide, it is appropriate for the insurer to comment on charter applications, but the decision to grant a charter must rest with the primary supervisor. It is proper that the OCC establish capital standards for national banks. And, most importantly, the decision to take enforcement actions and the decision to revoke a national bank's charter are appropriately vested in the OCC.

Mr. Chairman, my written statement addresses several other issues that you asked me to address: the desirability of a separate thrift industry, the appropriateness of changes in the banking agency's enforcement powers, and other matters. In the interest of time, however, I will stop here, underscoring what was said earlier: please craft the miracle.

Thank you very much.

[The summary of testimony and complete prepared statement of Robert L. Clarke follow:]

For release:
February 28, 1989, 10:00 a.m.

SUMMARY OF TESTIMONY OF ROBERT L. CLARKE
COMPTROLLER OF THE CURRENCY
Before the
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
February 28, 1989

The Administration's proposal to recapitalize and reorganize the thrift deposit insurance fund and enhance the supervision of the thrift industry represents a workable solution to deal with an obvious emergency. Due to the need to act quickly, that plan does not address broader reforms regarding competitive opportunities for banks that need to be implemented in the future. As we move toward a solution to the present emergency, we must not lose sight of the other changes that are necessary to enable us to maintain a healthy, competitive banking system.

REGULATORY AND SUPERVISORY DIFFERENCES

There are two fundamental differences in the ways that banks and thrifts are regulated. First, the same agency that supervises thrifts also insures their deposits; in banking, these functions are provided by separate agencies. Second, thrift regulators operate under a statutory mandate to promote the home finance lending that they are charged with supervising; bank supervisors have no such promotional role.

Supervisors and insurers have different functions. Throughout the history of federal insurance of commercial bank deposits, the supervision of banks and the insurance of deposits have been the responsibility of separate agencies. The Administration's proposal would, for the most part, extend that separation to the thrift industry; although in response to the emergency conditions in that industry, it gives the deposit insurer some greater supervisory authority over thrifts than it has over banks. The Federal Home Loan Bank System would be established as an agency within the Department of the Treasury and would be headed by one person. The FHLBS would have primary responsibility for day-to-day supervision of federal thrift institutions and would be the principal federal supervisor of state-chartered thrifts. Under the Department of the Treasury, the FHLBS would have the same degree of independence the OCC has had since 1863.

As the supervisor of national banks and a member of the Board of Directors of the FDIC, it is clear to me that the division of responsibiliies between supervision and insurance is critical to ensure that the safety of the insurance fund will be balanced

against the need for competition and innovation in the market for financial services. A deposit insurer's most immediate objective is to preserve the insurance fund. In an insurer's ideal world, there would be no bank failures, and the insurance fund balance would never decline. Consequently, an insurer can be expected, as long as it is solvent, to take an aggressively conservative approach to bank supervision. Promising but unproven activities are likely to be resisted because of their uncertain effects on the volume of insurance claims.

In contrast, the bank supervisor's principal objective is to foster the health and stability of a delivery system that provides the financial services that customers demand. The supervisor's view is that bank failures are not always a signal that the system is in trouble, but may simply be a natural consequence of the operation of a private market in which some enterprises succeed and others do not. The supervisor is more likely to be receptive to measures that will increase competition. Similarly, the bank supervisor is more likely to look favorably upon innovations that, although they entail some risks, will enable banks to adapt to changing demands for financial services.

I do not want to give the impression that bank supervisors ignore the risks taken by insured institutions or that we are unconcerned with the adequacy or safety of the insurance fund. Much of our supervisory effort is geared toward making sure that banks have in place the systems that enable them to evaluate, manage, and control risks. Our recent guidelines regarding national bank participation in highly leveraged transactions reflect that approach. Occasionally, however, the supervisor's preventative, anticipatory measures do not succeed in preventing losses that deplete capital. The supervisor then must promptly close insolvent institutions to protect the insurance fund. To enhance our ability to time closures so as to minimize losses to the insurance fund, we are undertaking efforts to refine our definition of insolvency. Our goal is to make sure that risks taken by private institutions expose their owners' capital, rather than depositors or the deposit insurer, to risk.

THE NEED FOR A SEPARATE THRIFT INDUSTRY

In recent years, segmentation in financial markets has broken down under the onslaught of new technology, interest rate volatility, and the growing practice of both borrowers and lenders to engage in cash management. Banks face dramatic competition in commercial lending from other providers of financial services. Thrifts compete in the mortgage market with banks, mortgage brokers, insurance companies, and other financial institutions. For example, General Motors Acceptance Corporation now services a greater dollar volume of mortgages than any thrift. Thrifts once played a unique role in ensuring an adequate supply of home financing, but this is clearly no longer the case. These developments are part of a larger trend toward a financial service industry in which the products and services offered by a financial institution are largely determined by its business strategy rather than its charter type.

The question facing policymakers is therefore not whether to do away with a separate thrift industry; the distinctions between certain thrifts and banks will continue to diminish, whatever regulatory policies are adopted. The question is: What changes in the regulatory framework of thrifts are needed to ensure that financial service companies of whatever type will serve the public interest efficiently in an increasingly competitive market? As the roles played by thrifts and banks in the market become more similar, it becomes increasingly important that they both adhere to the same set of supervisory rules, regulations, and procedures. Of particular importance is the elimination of differences in accounting standards, capital requirements, and closure rules.

AMENDMENTS TO ENFORCEMENT POWERS

The enhanced authority provided by the bill would give the regulatory agencies useful tools to strengthen their current enforcement programs. With regard to civil remedies, the proposal would expand the scope of persons who could be reached by enforcement authority. Another provision would clarify the regulators' ability to initiate a temporary cease and desist action when an institution's records are so incomplete or inaccurate that the regulators cannot determine the condition of the institution.

An important feature of the proposal is the increase of civil money penalties. We believe that higher penalties may be appropriate in situations where violations or unsafe and unsound practices are of a short duration but have a substantial detrimental impact on an institution. Although we believe that it is a good idea to increase civil money penalties, we also think it is critical to strike a balance. Efforts to weed out a few bad people must not discourage honest and qualified individuals from serving as bank directors.

Finally, the allocation of $50 million to the budget of the Department of Justice, specifically to address the problems of bank fraud, is extremely important. It is essential to consistent prosecution of white collar crime cases that a cadre of personnel be established to focus continuously on these cases.

For Release:
February 28, 1989, 10:00 a.m.

TESTIMONY OF
ROBERT L. CLARKE
COMPTROLLER OF THE CURRENCY
Before the
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
February 28, 1989

Mr. Chairman and members of the Committee, I am pleased to have this opportunity to present my views on the Administration's emergency proposals to resolve the problems of the savings and loan industry. The perspective that I bring to this plan comes from being the regulator and supervisor of national banks and also a member of the Board of Directors of the Federal Deposit Insurance Corporation (FDIC). From this unique vantage point, I have gained a practical understanding of the responsibilities of both the supervisors and insurers of depository institutions.

Supervisors and insurers have different but very important functions. The Office of the Comptroller of the Currency (OCC) was created in 1863 during the Presidency of Abraham Lincoln. It was then, and is now, the primary regulator and supervisor of the nation's federally chartered banks. We are responsible for examining and supervising approximately 4,300 national banks, which hold over 60 percent of commercial bank assets. It is my duty to determine, based on the professional judgment of the OCC's National Bank Examiners, when to grant a national bank charter, when to declare a national bank insolvent and revoke its charter, and when to take the myriad of other actions that are required as national banks conduct business. On the other hand, the insurer of commercial bank deposits, the FDIC, is charged with overseeing state-chartered institutions, in conjunction with state supervisors, and with disposing of banks that have been declared insolvent by their primary regulator, either by finding merger partners or other acquirors or by liquidating them.

The Administration's proposed plan, which Treasury Secretary Brady discussed with you last week, represents a workable solution to deal with an obvious emergency. Because of the need to deal with this emergency, that package does not address broader reforms regarding competitive opportunities for banks that I have discussed with the Congress on numerous occasions and that I still believe need to be implemented. Also, we may find that some of the regulatory and institutional arrangements contained in the Administration's proposal need to be fine-tuned at a later date. I hope that as we move toward a solution to the present emergency, we do not lose sight of the need to consider, in the future, the changes that I believe are necessary to enable us to maintain, over the long term, a healthy, competitive banking system--a system that is able to deliver to customers the financial services that they desire and that are, in many instances, already being delivered by the principal competitors of banks.

Secretary Brady presented you with details on the Administration's calculations of the magnitude of the problem of the savings and loan industry and the plan to raise the funds needed to restore that industry to health. Because it has been the responsibility of the Secretary's staff and the Office of Management and Budget to develop those figures, I have nothing to offer on that subject.

Rather, I want to discuss with you, first, why the condition of the banking industry makes it appropriate that the Administration's emergency legislative proposal focus primarily on savings and loan institutions, which I will refer to as "thrifts". I also want to discuss how the plan would affect commercial banks, and address the importance of having a healthy separation between the primary supervisor of banks and the deposit insurer. Finally, I want to respond to the Committee's question regarding the need for a separate thrift industry and to review the changes in the banking agencies' enforcement powers that are proposed in the Administration's bill.

SOUNDNESS OF THE BANKING INDUSTRY

I want to emphasize at the outset that the banking industry is basically sound. Consequently, it is appropriate at this time to deal with the thrift problem and not undertake a sweeping overhaul of the mechanisms by which banks are supervised and insured. When final results for 1988 are in, we expect net income for all commercial banks to exceed $20 billion. Also, the equity capital of commercial banks has risen in the past two years. For the median commercial bank, equity capital reached 8 percent of assets at the end of the third quarter of 1988.

Still, there are many signs that the banking system is suffering from increased competitive and market pressures. Even with the improved profitability of 1988, return on assets and return on equity are still significantly below the levels of the late 1970s. Moreover, banks continue to suffer loss of market share to other financial service providers. For example, from 1977 to 1983, bank loans made up 37 percent of all credit raised by U.S. nonfinancial corporations. For the 1984 to 1987 period, this figure declined to 18 percent.

Most seriously, 1988 brought the largest number of bank failures, at the greatest cost to the insurance fund, in the history of the FDIC. Last year, 198 commercial banks failed

(40 of which were owned by a single holding company), and an additional 21 received open-bank assistance from the FDIC. As a result of those failures, and of provisions made for several banks that will probably require assistance in 1989, the FDIC fund balance declined by $4.2 billion in 1988.

Nevertheless, the FDIC remains strong, with a balance of $14.1 billion, equal to approximately 0.8 percent of insured deposits. This level of coverage is an historic low. While in no danger of becoming insolvent, the FDIC insurance fund has been called upon to absorb some extraordinary losses. The good news is that it has been able to respond. But to restore the fund to historical levels, the Administration has proposed an increase in insurance premiums paid by commercial banks. The Administration projects that the proposed increase will return the fund to the present statutory target of 1.25 percent of insured deposits by 1999.

EFFECTS OF THE ADMINISTRATION PROPOSAL ON COMMERCIAL BANKS

The Administration's proposal, though not without cost for commercial banks, may, over time, improve their ability to compete. In the near-term, the expeditious exit of insolvent thrifts that bid up rates on insured deposits will help to relieve pressure on the profit margins of banks. Over the longer-term, the Administration's proposal will set in place a more rational structure for regulating depository institutions that will provide a level playing field for thrifts and banks. Thrifts have long been permitted to operate with significantly lower capital ratios than commercial banks. At the end of 1987, for example, bank equity capital averaged 6 percent of assets, while thrift regulatory capital, which includes non-equity components such as net-worth certificates and income-capital certificates, averaged only 3.7 percent of assets.

These differences would be eliminated by the Administration's proposal, which would require thrifts to meet the same capital standards as national banks. This requirement alone will answer one of the major concerns of commercial banks--that looser regulation of thrift institutions, which can offer many of the same products, gives thrifts an unfair competitive advantage over banks.

The Administration's proposal is designed to avoid any reduction of the integrity of the deposit insurance system for commercial banks. Although the FDIC would assume responsibility for administering the insurance of deposits in thrifts as well as in banks, two separate insurance pools would be maintained. There would be no transferring or commingling of funds. Bank insurance premiums would flow to the bank insurance fund, where they would be used exclusively to provide protection for commercial bank depositors. Furthermore, the current prohibition on the transfer of thrift institutions between the FSLIC and FDIC insurance pools, which is scheduled to lapse shortly, would be extended five years. Thereafter, the FDIC would have authority to charge an entrance fee to prevent dilution of the FDIC pool.

As President Bush stated on February 6, the Administration's proposal would not be painless for banks. At present, banks pay insurance premiums of 1/12 of one percent of domestic deposits--8.33 basis points. The proposal would raise the annual deposit insurance premium to 12 basis points in 1990 and to 15 basis points thereafter. We estimate that if the proposed increase to 12 basis points had been in effect during 1988, it would have added $730 million to the total insurance premiums paid by commercial banks. Had the full increase to 15 basis points been in effect, insurance premiums would have been $1.33 billion higher. Because the payment for deposit insurance is a pre-tax expense, the net effect of higher insurance premiums on the banking system's after-tax income would have been lower. Hence, the proposed higher insurance premium would adversely affect the overall profitability of the commercial banking industry, but would be unlikely to create unacceptable problems. Once the fund balance reached 1.25 percent of deposits, surplus revenues could be rebated to the assessed banks in accordance with current law, thereby lowering the effective cost of deposit insurance.

REGULATORY AND SUPERVISORY DIFFERENCES

Two fundamental differences between the way that banks and thrifts are regulated help to explain why the thrift industry has suffered so much more than the commercial banking industry during the tumultuous economic and financial events of the past decade. First, thrift regulators operate under a statutory mandate to promote the home finance lending that they are charged with supervising; bank supervisors have no such promotional role. Second, the same agency that supervises thrifts also insures their deposits; in banking, these functions are provided by separate agencies.

The Administration's proposal would make significant changes in the thrift regulatory structure. For instance, it would address the potential conflicts faced by a supervisor that also has a statutorily mandated promotional role by changing the composition of the boards of directors of the district Federal Home Loan Banks and by having the supervisory personnel within each district Federal Home Loan Bank report directly to the chief supervisory official of the Federal Home Loan Bank System (FHLBS). Importantly, the proposed legislation emphasizes that the mandate to support housing finance must be carried out in a manner that is consistent with safety and soundness.

The most dramatic change, however, would be the separation of the roles of deposit insurer and supervisor, and it is the importance of that separation that I want to emphasize.

Differing Objectives of Supervision and Deposit Insurance

Throughout the history of federal insurance of commercial bank deposits, the supervision of banks and the insurance of deposits have been the responsibility of separate agencies. The Administration's proposal would, for the most part, extend that separation to the thrift industry, although in response to the emergency conditions in that industry, it would give the deposit insurer somewhat greater supervisory authority over thrifts than it has over banks. For example, the FDIC would have the authority to conduct an independent review of an application for a federal thrift charter and, by denying deposit insurance, have the ability to override a chartering decision of the FHLBS.

Administration proposal for thrift supervision and deposit insurance. Under the Administration's proposal, the Federal Home Loan Bank System would be established as an agency within the Department of the Treasury and would be headed by one person. The FHLBS would have primary responsibility for day-to-day supervision of federal thrift institutions and would be the principal federal supervisor of state-chartered thrifts.

Under the Department of the Treasury, the FHLBS would have the same degree of independence the OCC has had since 1863. The independence of the OCC has a long tradition. Legislative history indicates that Congress recognized the need for independence at the time the OCC was created. This was reaffirmed in 1950 when Congress passed a bill reorganizing the Treasury Department and vesting all duties and powers in the Secretary of the Treasury with the exception of those of the Comptroller of the Currency. The original reorganization plan was rejected because the Comptroller's powers and duties would have also vested in the Secretary of the Treasury. The legislative history indicates that Congress believed that to adhere to the plan as originally proposed would "destroy the present independence of action and broad powers of the Comptroller", it would result in control by the President of quasi-judicial functions, and the Comptroller would no longer be insulated from political pressures. The Secretary of the Treasury also objected to the original plan vesting the Comptroller's powers and duties in the Secretary and stated that no new channel of authority was necessary.

The perception of Congress that independence is required is also reflected in other legislation. For instance, the Comptroller's term of office is not concurrent with that of the President or the Secretary of the Treasury. Moreover, funding for the OCC comes not from appropriations allocated by Congress, but rather from assessments made upon national banks. Indeed, Secretary Brady reaffirmed the importance of independence for bank and thrift supervisors when he testified to this Committee last week that the Treasury Department would not "micro manage" the FHLBS.

Under the Administration's plan, the reconfigured Federal Home Loan Bank System would not insure thrift deposits. That function would be transferred to the Federal Deposit Insurance Corporation. The FDIC would exercise enforcement powers that are directly related to the provision of deposit insurance--most notably, the power to revoke deposit insurance. And it would be provided emergency and expedited hearing procedures, which would permit it to revoke insurance more expeditiously than is possible today.

The separation of functions in two distinct agencies parallels the longstanding division of responsibility for bank regulation. The OCC is responsible for issuing charters, supervising bank practices, and closing insolvent banks. With respect to national banks, the FDIC is responsible for administering--and, when necessary, revoking--deposit insurance. The current process provides for considerable consultation between the two agencies: FDIC personnel participate with the OCC in the examination of some troubled banks, and the FDIC consults with the OCC before initiating insurance revocation proceedings. Yet, appropriately, the two agencies have distinct and separate responsibilities.

The importance of separation. The division of responsibility is critical to the achievement of an important policy objective: It ensures that the safety of the insurance fund will be balanced against the need for competition and innovation in the market for financial services, which necessarily entails some risk.

A deposit insurer's most immediate and obvious objective, like the objective of any other insurer, is, and must be, to preserve the insurance fund. In an insurer's ideal world, there would be no bank failures, and the insurance fund balance would never decline. An insurer naturally tends to view banking activities predominantly in terms of the threat they may pose to the insurance fund, rather than in terms of the value they may provide to bank customers. Consequently, an insurer can be expected, as long as it is solvent, to take an aggressively conservative approach to bank supervision. Promising but unproven business activities are likely to be resisted because of their uncertain effects on the volume of insurance claims. These observations are not theoretical--they come from three years as a director of the FDIC.

In contrast, the bank supervisor's principal objective is to foster the existence of a system that delivers the financial services customers demand, while maintaining the health and stability of that system. The supervisor's view is that bank failures are not always a signal that the system is in trouble; instead a failure is often a natural consequence of the operation of a private market in which some enterprises succeed and others do not. The supervisor is, therefore, more likely to be receptive to measures that will increase competition, such as new entry into markets, even though they may pose business challenges for individual banks. Similarly, the bank supervisor is more likely to

look favorably upon innovations that, although they entail some risks, will enable banks to adapt to changing demands for financial services.

On the other hand, I do not want to give the impression that bank supervisors ignore the risks taken by insured institutions or that we are unconcerned with the adequacy or safety of the insurance fund. The OCC recognizes the potential dangers to the banking system when bankers fail to manage properly the risks they assume. Much of our supervisory effort is geared toward making sure that banks have in place the systems that enable them to evaluate, manage, and control risks. Our recent guidelines regarding national bank financing of leveraged buy-outs and other highly leveraged transactions reflect that approach. The guidelines are not aimed at prohibiting bank activity in that area, but are intended to focus the attention of our examiners and of bankers on how well the activity is managed by banks.

In addition to providing preventative, anticipatory supervision and working with banks to resolve problems when they occur, one of the most important steps that a bank supervisor can take to protect the insurance fund is to close insolvent institutions. It is the practice of the OCC to close banks when their book capital is depleted. To enhance our ability to time closures so that the market value of a bank's capital is not negative, we are undertaking efforts to refine our definition of insolvency. Our goal is to make sure that risks taken by private institutions expose their owners' capital, rather than depositors or the deposit insurer, to risk.

In my view, separating the supervision and insurance functions for the thrift industry and maintaining that separation for commercial banks is one of the most crucial components of the Administration proposal. Thus, for the reasons I have discussed, I disagree with the recommendations of the FDIC staff report on deposit insurance reform to change current practice and give the insurer broad regulatory and supervisory powers over insured institutions. As the Administration proposal provides, it is appropriate for the insurer to comment on charter applications, but the decision to grant a charter should rest with the primary supervisor. It is proper that the OCC establish the capital standards for national banks and that the Federal Reserve System adopts standards for the state-chartered banks that are under its jurisdiction. We have just witnessed a practical example of how coordination in this important area can work with the recent adoption by the three agencies of substantially identical risk-based capital guidelines. Most importantly, the decision to take enforcement actions against national banks and the decision to revoke a national bank's charter appropriately rest with the OCC.

There are a number of means for facilitating coordination between the insurer and primary regulator. The Comptroller is a member of the Board of Directors of the FDIC and has been since the

FDIC was established in 1933. Current authority allows the FDIC to examine any national bank and have access to all OCC examination data concerning national banks. Also, the FDIC has the ability to revoke the deposit insurance of an insured bank, and would be able to do it much more expeditiously under the President's proposal. This relationship has worked well since the creation of federal deposit insurance, and there is no need to change it.

THE NEED FOR A SEPARATE THRIFT INDUSTRY

In your invitation to testify today, you specifically asked me to respond to the question of whether a separate thrift industry is needed. I would phrase the question differently. The issue is not, in my judgment, whether to do away with a separate thrift industry. Instead, the issue is: What do we want our financial service system to provide as we move into the 1990s, and is our present system the most efficient and the most competitive provider?

The current system of regulating commercial banks and thrifts dates from the 1930s, a period in which the market for financial services was highly segmented and quite different otherwise. Government restrictions on interest rates and permissible services, reinforced by the habits of investors and borrowers, resulted in differences between banks and thrifts. They differed on both the asset and the liability sides of their balance sheets. Commercial banks specialized in noninterest bearing demand deposits and short-term loans to business firms; thrift institutions specialized in fixed-rate personal savings accounts, and, at the time, long-term residential mortgages. Other types of financial institutions, including investment banks and insurance companies, occupied equally specialized and protected niches of the broader financial services market.

In recent years, segmentation in financial markets has broken down with the onslaught of new technology, interest rate volatility, and the growing practice of both borrowers and lenders to engage in cash management. Thrift institutions and banks face increased competition for household savings from nontraditional institutions, such as money market mutual funds. Thrift institutions must compete for mortgage originations with banks, mortgage brokers, insurance companies, and other financial institutions. A critical factor in the increased competition faced by thrift institutions has been the creation of mortgage-backed securities, which has enhanced the liquidity of the secondary market for residential mortgages and facilitated the entry of nontraditional lenders into the mortgage market.

Consequently, thrift institutions now face substantial competition. Roughly 60 percent of mortgage credit is provided by commercial banks and mortgage companies. The largest originator of mortgages is Citicorp. Perhaps even more revealing, General Motors

Acceptance Corporation services a greater dollar volume of mortgages than any thrift. Thrifts once played a unique role in ensuring an adequate supply of home financing, but this is clearly no longer the case.

Furthermore, increased interest-rate volatility has made it unwise for a thrift (or any other short-term funded financial institution) to concentrate its asset portfolio in long-term fixed-rate loans such as residential mortgages. In recognition of this problem, the Congress gave thrift institutions broad authority to participate in other types of lending and business activities.

That significant development was part of a larger trend--which also includes the move toward greater competitive opportunities for the banking industry--toward a financial service industry in which the products and services offered by a financial institution are largely determined by its customers' demand and its management's strategy rather than its charter type. Many large thrifts are becoming indistinguishable, in the composition of both their assets and their liabilities, from commercial banks. At the same time, many small community banks bear a close resemblance to traditional thrifts. Equally significant, increasing numbers of thrifts are also dropping the words "savings" from the names that appear on their charter, and marketing themselves as "banks", "bancs", or "banques".

The question facing policymakers is not whether to do away with a separate thrift industry; the distinctions between certain thrifts and banks will continue to diminish, whatever regulatory policies are adopted. The question is: What changes in the regulatory framework of thrifts are needed to ensure that financial service companies of whatever type will serve the public interest efficiently in an increasingly competitive market?

As the roles played by thrifts and banks in the market become more similar, it becomes increasingly important that they both adhere to the same set of supervisory rules, regulations, and procedures. Of particular importance, differences in accounting standards, capital requirements, and closure rules should be eliminated.

The simplest and quickest way to accomplish this goal is to modify the existing thrift regulatory structure to make it conform to the current banking structure. This is essentially what the Administration plan would do. The Federal Home Loan Bank System would be retained as a separate thrift regulator. It would parallel the OCC--the regulator of national banks--in most important respects, including its relationship within the Treasury Department. Similarly, the thrift industry's insurance fund would be managed by the FDIC.

Building on existing regulatory institutions in this fashion allows the Administration to move quickly to deal with the thrift crisis. Although some may argue that it would eventually be more efficient to place thrifts and banks under a single supervisor in a manner that mirrors the proposed administration of the deposit insurance funds, the continuation of separate bank and thrift regulatory agencies will work, too. But, clearly, thrifts and banks should employ a common set of regulatory standards.

AMENDMENTS TO ENFORCEMENT POWERS

The Administration's proposal also includes amendments to the enforcement powers of the federal bank regulatory agencies. These amendments are similar in scope and content to, but differ in certain respects from, the enforcement package jointly developed by the Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the National Credit Union Administration. That legislation was submitted to Congress last year and was passed by the Senate as S. 1886. Many of its key provisions were incorporated into H.R. 32, which was introduced in this session of Congress. The enhanced authority provided by the Administration's proposal would enable the regulatory agencies to fulfill their supervisory responsibilities in a more timely and more effective way. In particular, it would augment the OCC's current enforcement program.

OCC Enforcement Program

For many years, the OCC has maintained an active enforcement program geared to protecting the safety and soundness of the national banking system and ensuring a high degree of compliance with the law. Our enforcement policy emphasizes the appropriate use of all available formal and informal enforcement powers to deter insider abuse, prevent violations of law and unsafe and unsound practices, and ensure responsiveness to supervisory directives. The OCC, as a matter of course, makes criminal referrals to law enforcement authorities when there is evidence of criminal activity. For many years, the OCC has required national banks to file reports of crime with the United States Attorneys, the FBI, and the OCC. The OCC's efforts in preventing insider abuse were recently recognized in a report issued October 13, 1988, by the House Committee on Government Operations. The report commended the OCC for its vigorous enforcement against insider abuse and for its cooperation and coordination with law enforcement agencies in criminal matters.

Through working groups in Washington and in the OCC's district offices, we work closely with the law enforcement community. The OCC actively supports prosecutions in individual cases by providing documentation and examiner expertise. Frequently, we have made our examiners available to assist grand juries or to act as consultants to prosecutors. For over a year, the OCC has detailed to the Department of Justice a staff attorney to assist, on a full-time basis, the investigation and prosecution of fraud cases centered in

Oklahoma City. For two years, two OCC examiners were detailed to the U.S. Attorney's Office in the Southern District of New York to assist in the investigation, preparation, and successful prosecution of criminal charges brought against the two principals in the Golden Pacific National Bank case. These examples illustrate not only the active involvement of the OCC in the prosecution of criminal activity, but also the time and personnel that are required to prosecute each case to its conclusion.

On another level, the OCC is proud of its participation in the Bank Fraud Working Group, which was established by the Attorney General and the heads of the federal financial institution regulatory agencies. It is made up of senior staff members from the regulatory agencies and the Department of Justice. The purpose of the Working Group is to examine and improve the entire federal law enforcement response to bank fraud cases. Since its inception, the Working Group has enhanced coordination and cooperation at all levels, established improved record-keeping and tracking systems for criminal referrals, developed white collar crime training courses, and identified regulatory and legislative changes needed to remove impediments to closer coordination among the agencies.

The OCC believes that its efforts have been effective; we also believe that the additional enforcement authority provided in the Administration's proposal would enhance our overall enforcement capacity.

Enforcement Provisions in Administration's Proposal

With regard to civil remedies, the proposal would provide us with additional flexibility by expanding the scope of persons who are reachable by the enforcement authority. The proposal would clarify the authority to obtain affirmative relief, such as restitution or reimbursement, in cease and desist actions when a person has engaged in abusive insider transactions. Another provision would clarify the regulators' ability to initiate a temporary cease and desist action when an institution's records are so incomplete or inaccurate that the regulators cannot determine the condition of the institution.

We recognize that the suspension and removal authority should only be used for serious infractions, but we believe that certain amendments to this power are necessary to achieve more effective enforcement. The Administration's proposal for a system of industry-wide cross removals would make certain that a person who is suspended or removed from an insured bank also is suspended from other financial institutions, such as savings and loan associations and credit unions. This would ensure that a person that harms one institution would not be free to harm another. Other amendments would clarify that the regulators retain the ability to bring a prohibition action against an individual for offenses committed in a bank although the individual has subsequently left the bank or the bank has failed.

An important feature of the enforcement provisions of the Administration's proposal is the increase of civil money penalties from up to $1,000 per day to $25,000 per day, with penalties of up to $1 million per day for actions taken in reckless disregard for the safety of the institution. Although we believe it is a good idea to increase civil money penalties, we also think it is critical to strike a balance. Efforts to weed out a few bad people must not discourage honest and qualified individuals from serving as bank directors. Even under current conditions, some banks are having trouble recruiting the best people to serve as directors because of the magnitude of the liabilities to which bank direcctors may be exposed.

We also believe that significantly higher penalties, such as the ones included in this proposal, may be appropriate in situations where violations or unsafe and unsound practices are of a shorter duration but have a substantial detrimental impact on an institution. The OCC supports expanding the authority of regulators to assess penalties for violations of written conditions imposed in the process of approving an application, for the breach of fiduciary duty, or for engaging in an unsafe or unsound practice that results in a substantial loss to the financial institution or gain to the individual.

The Administration's proposal recognizes the need to enhance the criminal enforcement authority as a logical accompaniment to the changes in the civil statutes. The increase in criminal penalties and the addition of civil penalties of up to $1 million per day for violations of provisions of the criminal statutes should provide another effective deterrent to criminal activity affecting financial institutions. Bank crimes are particularly difficult and complex prosecutions. The authority to assess civil penalties, which parallels the criminal provisions, will provide the government with an additonal remedy.

The OCC also endorses changes to the current sentencing guidelines, which would increase the severity of sentences handed down in bank fraud cases. More severe sentences would serve as a further deterrent to dishonest individuals who might harm a financial institution.

Finally, the authorization of $50 million per year for each of fiscal years 1989 through 1991 to the Department of Justice, specifically to address the problems of bank fraud, is extremely important. It is essential to consistent prosecution of white collar crimes that a cadre of personnel be established to focus continuously on these cases. The expertise that is needed to prosecute these cases must be built and retained. Prosecution is harder to accomplish when prosecutors only occasionally handle an isolated case.

CONCLUSION

No problem of the magnitude of the current thrift crisis can be solved without pain. What can be done is to inflict the pain fairly, and where it belongs, without imposing a crushing burden on any one set of persons or institutions. The Administration's proposal requires healthy thrifts to pay for a substantial portion of the cost of resolving the insolvency of their industry's insurance fund, but not to shoulder the entire burden. Commercial banks need, and would be required, to shore up their deposit insurance fund, but they will not be asked to contribute to the resolution of the problems of the thrift industry. Some of the burden will unavoidably be absorbed from general revenue, but not until all other reasonable sources of funds have been tapped.

The OCC will share some of the burden for resolving the thrift problem. Approximately 150 of our National Bank Examiners have been assigned full-time to deal with the most troubled thrifts. They will take the lead in examining approximately 60 of the more than 200 thrift institutions expected to be placed into conservatorship by the FDIC. Although this effort will reduce the time we have available to supervise national banks, I am proud that we are able to make a substantial contribution to the effort to deal with the current emergency. I would also note that the OCC will be reimbursed for this effort, so the cost will not be borne by the OCC or by the national banks which fund the OCC's operations.

Although the thrift crisis has exacted a high price, it has also created an opportunity to make improvements in the regulatory framework of our financial markets, for which it would otherwise be difficult to build a consensus. Central among those improvements is the extension to the thrift industry of the separation of supervisory and insurance functions, a concept that has served the banking industry for over fifty years and has allowed it to make it through the turbulent financial markets of the past few years in a sound condition.

I commend you, Mr. Chairman and members of the Committee, for holding these timely hearings. I sincerely hope that you will address the thrift problem at the earliest possible time. You have before you a proposed solution. I believe that it will work. Please urge your colleagues to inform themselves about the issues--and to act promptly to provide the structure and the funding that will allow the savings and loan industry to deal with its current emergency.

The CHAIRMAN. Well, we need your help and the help of all others in doing that, but we are determined to get this bill done in record time.

I must say, just so that everybody understands in some fashion how complicated this is, I remember when this committee did the Chrysler loan guarantees. Very complex piece of legislation. It turns out we did it pretty well because it worked and a lot of negative consequences were avoided. The Government made a lot of money.

But it took us a full year to put that package together.

Senator GARN. Notice how he turned to me and said "a lot of money"? Because I opposed the Chrysler loan guarantee.

I saw that look, Mr. Chairman. [Laughter.]

The CHAIRMAN. In any case, I think we would agree that it was enormously complex and it did take us fully 1 year to do it, and it was unique in its construction. At the time on legislative matters that I have seen over some 15 years that was about as complex a package as I had ever seen. I would put on a scale of 1 to 10 at about a 10 in complexity.

When I try to put the Chrysler situation on a scale of 1 to 10 in complexity with respect to the problem we are now facing with the savings and loan system, where we have lost $100 billion or more and having to try to repair the system, I would say that on a scale of 1 to 10, putting this new problem on that scale, that the Chrysler situation is about a 1 and this problem is about a 10, and we don't have a year to do it.

We are going to have to do it a lot faster than that, and it is going to be very difficult to do it the way we would all like to do it. The pressures of time really limit our ability to be able to refine this to the degree that we would like to and I think probably should, but we are not going to have that luxury. So we are going to have to do the best we can in the time constraints that we have, and we will do so.

Let me ask you this. In your time as Comptroller, what have been the most difficult aspects of your relationship with the Treasury Department that you have had to deal with? I mean, what are just the built-in difficulties?

DIFFICULTIES BETWEEN COMPTROLLER AND TREASURY

Mr. CLARKE. Mr. Chairman, to be totally candid with you, the biggest problem that I have experienced in the 3 years I have been Comptroller has been the inability to get our compensation adjusted so that we could be competitive. We need to be competitive, first of all, with the industry, which used to be the principal swipers of our personnel. Then along came the Federal Home Loan Bank Board, with which we are terribly uncompetitive, and now we are the low man on the totem pole with respect to any Federal bank regulatory agency, not by just a little bit, but by a lot.

But as President Bush said in his Inaugural Address, there is a new breeze blowing. I believe that there is a greater recognition that we do need to be competitive, and, as you note, in the bill that has been presented by Secretary Brady that problem will be remedied. We can scratch that off the list as past history.

There are other problems, of course, associated with being part of an executive branch agency, but they are certainly not ones that can't be overcome, and I don't know that they even rise to the level of being other than a minor irritant.

The CHAIRMAN. Yes. Let me be a little more blunt, then, and give you an occasion to be blunt in return if you are interested in doing so or have something to say on this subject.

Other than the difficulty of retaining good people because you have been boxed on the salaries that you can offer, have there been other times when you have wanted to act and you have found that either the Treasury Department or the OMB because of just the normal bureaucratic arrangements have limited your ability to act the way you felt you needed to on a timely basis?

Mr. CLARKE. Mr. Chairman, in the 3 years that I have served in this job, there has not been a time when we requested additional personnel where we were turned down by either the Treasury or OMB in any material respect, certainly not in a way that has hampered our ability to function. We, of course, are required to clear our testimony before the Congress, as is any other executive branch agency, with OMB. That is in that category of nuisances that I described. But I would have to tell you honestly that I have not felt pressure from either the Treasury or otherwise from the executive branch to take or not take particular policy initiatives except in the area of compensation, which has been a serious problem.

The CHAIRMAN. Maybe that is the question—maybe that is the answer to the question I asked, but I am not sure. So let me just make sure that we are really understanding one another.

I am saying apart from personnel issues and fundamental differences of opinion on policy, I am asking you as to whether or not just the bureaucratic arrangements have been such that you have been able to act on a timely basis in the way that you felt to do so in each and every instance.

Have there been any occasions where just the systems apparatus in which you have to function have required a longer period of time to implement something that you felt needed to be implemented apart from whether or not there was in fact a pressure to try to change your policy along the way?

Mr. CLARKE. Not really. In the unfortunate days of Gramm-Rudman and apportionment, some in the administration wanted those provisions to apply to all of the bank regulatory agencies. That legislation did handicap us. Our examiners were kept from traveling. We were kept from getting in the banks. We had to make some severe cuts in our planned expenditures. But that has been fixed. That is past history. Sometimes these ideas are slow in coming, but they at least have come.

The CHAIRMAN. Thank you.

Senator Garn.

Senator GARN. Thank you, Mr. Chairman. I would just follow up along this line.

I think the Comptroller knows very well what our positions have been on apportionment, and that we had some knock down, drag out arguments with OMB over that. We had a difficult time winning but the Chairman and I did win on that issue.

Mr. CLARKE. I appreciate that support.

Senator GARN. But I certainly totally and completely agree with both you and Mr. Seidman about the need to separate the insurance function from the supervision function, and the administration is right to recommend that.

Where I do disagree—and the only major disagreement I have with this plan—is making the new Federal Home Loan Bank person, Chairman, whatever they are going to call him, part of Treasury. I outlined to the Secretary of the Treasury last week, in some detail, that the Fein study, the Hunt Committee findings, and all of the history about this, recommend that the Comptroller be made independent and taken away from Treasury. This was before we ever got into the debate of the need to change the relationship of FSLIC and the Federal Home Loan Bank Board.

I still do, even though you have just testified in response to the chairman's questions that you have had no major problems with this. On the other hand, let's turn it around. As the primary regulator of national banks, what justification is there for being under Treasury, or any other executive department rather than being an independent agency reporting directly to the President?

If I had my way, I would not only restructure the Federal Home Loan Bank Board, as recommended, but I would have it remain independent and reporting to the President. I would remove your position from Treasury and do the same thing with it, because a number of studies over the last 15 to 20 years would support this action.

JUSTIFICATION FOR FHLBB BEING UNDER THE TREASURY

Mr. CLARKE. Some of the rationale for moving the thrift regulator under Treasury has been a concern that we are dealing with a problem that is expected to cost the Treasury a substantial amount of money and that if the Treasury is going to stand behind——

Senator GARN. Well, but on that theory that the Treasury takes care of the people's money, everything in Government should be under Treasury then because their money is at risk.

Mr. CLARKE. I understand, Senator Garn, that that could be carried to an extreme, but we are addressing an emergency situation that really deals just with the thrifts.

The other point that I would make concerns operational efficiency. Chairman Seidman said earlier that he would prefer to keep a three-person board, and I agree. I think our FDIC board is particularly efficient because all three of us have such a good working relationship with each other. But even more efficient than a three-person board is a one-person head at an agency like the OCC. There may be some who say that is not a good idea as a matter of policy, but I can tell you from a matter of operating efficiency, it is a very desirable way to go. That may be a worthwhile trade-off.

Senator GARN. I don't have any problem with that. The other side of that coin is that from an accountability standpoint there is only one person to blame, which has some merit as well.

I have no further questions at this time.

The CHAIRMAN. Thank you, Senator Garn.

Senator Shelby.

Senator **SHELBY**. Thank you, Mr. Chairman.

Mr. Clarke, there has been some talk in the press—and then in your opening statements you add a little to it—bringing out the distinction that we are aware of between your function as the Comptroller of the Currency, as a supervisor, and Mr. Seidman's function as the Chairman of the Federal Deposit Insurance Corporation.

I realize, and you certainly realize in your statements in clear language, that they are two different functions, but sometimes don't these functions overlap in a sense? In other words, you as a supervisor are interested in healthy but growing banks; as the Chairman of the FDIC, the Chairman is interested in, sure, a healthy fund that he wants to protect, as you say, the insurance—the assets of the insurance funds, but also the integrity of the bank, the soundness of the bank.

Do you want to comment on that?

Mr. **CLARKE**. I would agree with that. In fact, I said in my opening statement that there clearly is some overlap.

Senator **SHELBY**. Overlap.

Mr. **CLARKE**. And both of us are interested——

Senator **SHELBY**. But a big distinction, too, isn't it?

Mr. **CLARKE**. Yes.

Senator **SHELBY**. Would you want to elaborate on that distinction, as you see it, between your role as the Comptroller of the Currency, as a supervisor, and the FDIC as looking after the funds and the soundness?

Mr. **CLARKE**. The principal distinction, Senator, is that the insurer's primary responsibility is and should be to protect the insurance fund. One of the ways you protect the insurance fund is by promoting a healthy banking industry. On the other hand, one of the ways you protect the insurance fund is to cut back on the amount of risk that that industry can take and, as with everything in life, you can carry that to an extreme if you are not careful.

The point I was trying to make is that by having that tension that exists between the primary regulator and the insurer, you keep from reaching those extremes. You keep the primary regulator from authorizing all kinds of crazy things for national banks because the FDIC retains the right to remove deposit insurance from those banks. At the same time, you keep the insurer from squeezing down the activities in which the banking system can engage to the point that it can't be healthy.

Senator **SHELBY**. Can I take it a step farther down the road, because this committee before—and I am sure we will be into it again—the deregulation of the banks and the roles that they would play and the role that the FDIC plays in insuring the deposits of the millions of people in America and making sure those deposits are not used improperly in any kind of a deregulation scheme down the road?

You alluded to that. In other words, make sure that the capital of the stockholders is used, for an example, investment banker banking risk and not the FDIC backing it up.

Is that a valid concern?

Mr. **CLARKE**. That is a very valid concern, and I agree that that is the way it should be done.

One thing that Chairman Seidman didn't mention that I think is important for the committee to remember is that the FDIC has acted in this respect in connection with State-chartered banks. As you know, State nonmember banks are permitted under Glass-Steagall to engage in some securities activities. The FDIC, in the very manner that Chairman Seidman advocated has promulgated a regulation that says to those State banks, we are not going to tell you that you can't engage in the activity if your State has authorized you to do so, but if you are going to engage in it, you have to engage in it through a bona fide subsidiary that has in place many of the same types of firewall protections that were adopted by this committee and by the Senate last year. You created some tougher firewalls and some additional firewalls than exist under the FDIC's regulation, but the concept is the same, and that can be applied to any kind of banking activity, not just securities activities. In fact, the OCC encouraged the committee to allow national banks to engage in securities activities utilizing exactly the same mechanism.

Senator SHELBY. But that mechanism, looking down the road toward proposed legislation that could come out of this committee, that is a very important point to make and those walls should be secure and strong to protect the FDIC.

Mr. CLARKE. Absolutely, they should.

Senator SHELBY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Clarke, you mentioned that you had been well-received by the OMB with your request for additional supervisory personnel.

Mr. CLARKE. Yes, sir.

Senator GRAHAM. In some testimony before this committee, the former Chairman of the Federal Home Loan Bank Board, Mr. Ed Gray, had given a different picture, that in fact his request for increases had resulted in decreases, and he gives that as a primary factor in why we are holding these hearings today.

Why do you think OMB would have had a different standard of treatment for your office and the Home Loan Bank Board, or do you believe that Mr. Gray accurately reported the way in which the Home Loan Bank Board was disposed of?

Mr. CLARKE. Senator, I can't comment with any firsthand knowledge about that because it took place before I became Comptroller. I have no reason to doubt that Chairman Gray had that problem, but I can't speculate with you about why it occurred. All I can say is that it has not been a problem during the time that I have been in this job.

Senator GRAHAM. You are saying that since you have been on the job the Home Loan Bank Board and the Office of the Comptroller of the Currency have been treated in a parity manner?

Mr. CLARKE. Again, I can't speak for the Federal Home Loan Bank Board. I am not aware of the Bank Board having a problem in being able to attract enough people. Lord knows, they have attracted enough of them from the OCC. But we have not had any restrictions.

Senator **Graham**. On the issue of your objection to FDIC being given any additional powers relative to bank regulation, are there some specific places in the legislation that has been submitted by the administration to this committee that you would recommend modifications?

TERMINATION OF DEPOSIT INSURANCE

Mr. **Clarke**. No, sir. The relationship between the OCC and the FDIC under the proposed legislation remains essentially as it is now, which is what we set out to accomplish, with one very important exception, which we support: the expedited ability of the FDIC to remove deposit insurance.

Terminating deposit insurance is a very tedious process currently, whether you are doing it with respect to a national bank or a State bank. There are times when we, as the primary supervisor of national banks, think that it is appropriate to remove deposit insurance, yet it takes 2 years or longer to get that done. So that is an important change and one that we support.

But the legislation as proposed strikes the right kind of balance. In my opening statement, I was not objecting to things that are in the bill but simply voicing my disagreement with the FDIC staff study. I think you heard Chairman Seidman say that he also was not looking for any changes in the bill.

Senator **Graham**. So the statement that was attributed to you in today's American Banker newspaper—he wants Congress to "resist the temptation or the urging in the FDIC report to give the insurer the ability to set all the rules and regulations under which national banks can operate"—that is a preemptory caution, not one that is suggesting surgery on the bill that is before us, is that right?

Mr. **Clarke**. That is correct.

Senator **Graham**. And you base that on the premise that regulators need to look at some additional factors relative to the range of activities of a financial institution?

Mr. **Clarke**. That the primary supervisor needs to consider other factors.

Senator **Graham**. One of the concerns I have, Mr. Seidman testified that the position of FDIC is that there are some banks that are too big or too important to fail because they would affect the whole financial structure and as a number of these banks have large amounts of foreign deposits which are not covered by FDIC insurance and do not pay a premium into the fund, but he would consider that they should be covered in the event of a failure.

Do you agree with that statement?

Mr. **Clarke**. There are a lot of misconceptions about what "too big to fail" really means. When you are talking about a large money center or a large Texas bank that failed, those banks did, in fact, fail. They simply failed in a manner which transferred their ownership to somebody else who took responsibility for all the deposits. The FDIC did not have to pay off any of those depositors, foreign or domestic, and the FDIC was able through the use of its resources to bring about a resolution to those institutions that was far and away less expensive than if they had been forced to liquidate the banks and pay off the depositors.

The FDIC also tries to do that wherever it can with respect to smaller institutions, but, unfortunately, there is often no interest in buying a bank of that type other than through a purchase and assumption where the FDIC has to take some of the assets. The FDIC tries to keep that from happening.

It is important to remember that those big banks that everybody is concerned about do fail. It is simply the manner in which they are resolved by the FDIC that is sometimes different.

Senator **Graham**. I interpreted that what Mr. Seidman was saying was that if the range of options got down to the question of should FDIC limit its insurance coverage to those depositors who are technically covered by their deposits being assessed premiums for the benefit of FDIC or should the insurance coverage be extended to other depositors, that in certain banks the answer would be that FDIC insurance would be extended to those noninsured depositors.

That was the definition that I think he was speaking of in the "too big to fail" scenario.

Mr. **Clarke**. It is an assurance to the global banking community that the regulatory system is not going to drive such institutions off the cliff, but rather is going to work toward a resolution of a failure, should it occur in one of those institutions, that will protect all the depositors, not by being paid off by the FDIC, but by having that institution taken over by somebody else. That is the way it is done in virtually every other country around the world.

Senator **Graham**. On another day, when we are discussing a different topic, the degree of supervision of commercial banks in their lending outside the United States, I would like to come back to this topic.

Mr. **Clarke**. I would be glad to discuss it with you.

The **Chairman**. Thank you, Senator Graham.

It has been a very valuable day. I appreciate the testimony of both witnesses. We will have questions for the record for you, Mr. Clarke, Comptroller Clarke, from others.

The committee will come back in session tomorrow morning at 10 a.m. We will have Danny Wall here, the head of the Federal Home Loan Bank Board, and with that the committee stands in recess.

[Whereupon, at 12:14 p.m., the committee was recessed, to reconvene at 10 a.m., Wednesday, March 1, 1989.]

PROBLEMS OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC]

PART II OF IV

WEDNESDAY, MARCH 1, 1989

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10 a.m. in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Cranston, Sarbanes, Dodd, Dixon, Shelby, Graham, Wirth, Kerry, Bryan, Garn, Heinz, D'Amato, Bond, Mack, and Kassebaum.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The Chairman. We welcome our witnesses to the table. We have Danny Wall, the Chairman of the Federal Home Loan Bank Board, here with us this morning, accompanied by people in his organization who he will introduce later.

I want to make a brief opening comment and then I will yield to Senator Garn, Senator Cranston, and Senator Wirth for the same purpose.

Today we are beginning our eighth day of hearings here in the Senate Banking Committee on the FSLIC issue. No institution or chairman of any of our financial regulatory agencies has a more vested interest in the outcome of the administration's proposal for handling the problems facing the thrift industry than does the Federal Home Loan Bank Board and its present Chairman.

I want to say I know the work there has been very difficult for this Chairman coming as he did at a point in time when the dynamics loose in the industry and building up over a period of years has been extremely difficult to have to deal with. While we may not always have agreed about each and every step along the way, I very much appreciate the dedication and the hard work that he and his people have invested in this assignment. It is a very difficult task and one that's fully appreciated by this committee.

One of the main purposes of S. 413, the Financial Institutions Reform Recovery and Enforcement Act of 1989, which has been introduced by myself and Senator Garn and others, is to break up the historically close relationship between the thrift industry and its regulator. I know that Chairman Wall supports this important concept underlying the bill as I also do.

The question remains whether the bill goes far enough in this respect or whether there are other steps that should be taken and the committee will look forward to hearing from Chairman Wall on this issue.

During the past few hearings, I have stressed my concern about the role played by State-chartered savings and loan institutions in contributing to the current FSLIC problem. By that, I mean State charters that go far beyond what the Federal charter would allow a federally chartered S&L. The facts show that in 1987 52 percent of all the money FSLIC spent on failed thrifts went to State-chartered institutions in just 2 States, Texas and California. We now have the data for 1988, and the situation was even worse. A full 59 percent of FSLIC's resolution expenditures went to State-chartered thrifts in these 2 States. Of the 59 percent, 50 percent went to Texas and 9 percent went to California.

I think it highlights again what we've been developing through our testimony and cross-examinations in that area.

I am most interested in Chairman Wall's recommendations for ensuring that this situation can never happen again. Specifically whether or not he would favor, as some have suggested, that the committee impose a flat prohibition on direct real estate investment and development for both Federal and State-chartered institutions.

We also welcome his vision, as Chairman of the Bank Board, of the future of the savings and loan industry and what its principal business focus should be looking ahead.

Also, whether the new regulatory entities, be it the FDIC or the Federal Home Loan Bank System, have sufficient regulatory authority over brokered deposits. Most importantly, what suggestions he would make to us for improving the administration's proposal.

I am also concerned about the structural arrangements. I'm sure Senator Garn will mention those and so I won't elaborate on those at this time.

Let me yield to Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

Let me welcome you, Chairman Wall and Board Members Martin and White. I'm sure, Dan, through some of these days you may wish you were still staff director for this committee rather than Chairman of the Federal Home Loan Bank Board. Some of the problems we went through over the years probably seem rather minor to you at this time.

I'm sure that testifying before Congress has long ceased to be a pleasure for any of you with all the criticism you've taken over the last 6 months. You've become the whipping boy of many in Congress and the media, receiving all of the blame for the problems of the thrift industry. I believe that is both unfair and wrong.

We politicians do not like to hear that we'll have to put the taxpayer on the line for billions because of high flyers investing insured deposits in windmill farms. We also don't like to hear that the problem has gotten much worse because of congressional failure to act.

Unfortunately, you are the people who brought us the news. Every action you took at the end of last year was a painful reminder that this problem is nasty and ugly. Our reaction has been to shoot the messenger. Never mind that you did not create the problem, that you took aggressive action to stop the worst abuses. You were there when we heard the bad news and now you're paying the price.

I think it is time to set the record straight about the many positive achievements that the Board has accomplished. I believe that your testimony does exactly that. Let me emphasize that I am not saying that every action you have taken or every deal that you have made has in my view been the best course of action. I have my own criticisms which I have shared with you before. I still believe that over all, under the absolute worst circumstances, you did the best job that could be done with so few resources.

I also believe that many of the best achievements of this Board have received very little publicity and I worry that the administration's plan may run roughshod over some of them in its zeal to apply bank regulatory standards to thrifts.

What few people realize is that most of the problems that we are seeing now were caused by actions that took place before 1985. That was when the really wild speculation occurred. Capital standards were weakened. Supervision was cut back and the Southwest economy took a nosedive. The dimension of the problem has certainly grown since then, but mostly because we lack both the human and financial resources to resolve the thrifts that had become braindead. It got worse not because their managers continued to speculate wildly in bad real estate deals. Instead they got worse because they had to suffer mounting operating losses just to keep their doors open. That problem is still with us. It will continue to be with us until we pass legislation to give the insurance fund the money it needs.

That is why we must move as quickly as possible, as the chairman and I have said many times. Since 1985, the regulatory situation has changed dramatically, particularly in the last 2 years on your watch. The number of regulators has doubled. Its quality has increased geometrically by all accounts. Capital standards have been beefed up, particularly with the new and innovative risk-based capital standard that accounts for interest rate risk. The rule governing direct or equity investments has been substantially strengthened. An early intervention rule has been proposed to close down thrifts before they become technically insolvent, a principle that has been widely endorsed by bank regulators and academics. And enforcement measures have been beefed up dramatically. In addition, strict growth limits have been placed on insolvent thrifts and their speculative practices have been stopped. Bill Seidman testified yesterday that the new task force of bank regulators has found very little to criticize in the Bank Board's controls on these institutions. He also acknowledged that very little could be done to stop further losses until Congress provides more funds.

These and other regulatory actions have put the thrift regulatory system on a much more sound footing than it was prior to 1985.

Unfortunately, they have been overlooked because of the criticism heaped on FSLIC's efforts to clean up the mess. I will work hard to keep these improvements in my colleagues' minds as we move forward with the legislation to make sure that we don't backtrack as we pass legislation.

I want to make one final point. Your aggressive action to resolve the worst FSLIC cases has been sharply criticized. If the Treasury's numbers are right, you dealt with nearly half the problem in the last year and a half, which by your own estimates has saved operating losses of $4 billion this year. GAO is revisiting your various deals and I wonder what more could have been done under the circumstances. Early on you were criticized for not moving quickly enough; then you were criticized for moving too quickly. I will do neither. You have acted in good faith to do the best job that you could and while not perfect—and all of us can sit back and say that if we had been in the shoes of the Board we probably would have done things differently in some respects, and I'm sure that's true—I believe it's the best that could have been done under the circumstances. I'd like to reemphasize my point that rather than continuing to dwell on the size of the problem, as Chairman Greenspan said the other day:

> It's time to place a plan in place, give the board the tools in which to close these institutions down, and stop the hemorrhaging, so that the problem doesn't continue to increase in size.

Again, I'm very pleased with Chairman Riegle and how rapidly he has moved to condense the hearing schedule. I fully expect that with his leadership in this committee, that the Senate will have a plan in place in April to give the regulators the tools they need. I can't speak for the House. In fact I'm probably the last one to speak for the House after 15 years of passing bills and sending them over there and seeing them die. But as far as the Senate is concerned, I'm sure we're going to place our mark on the administration's legislation. We will make the changes that we deem necessary and proper, and I think we'll have that out of this committee and on to the Senate floor in April.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn, for your kind personal comments.

Senator Cranston.

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. Thank you very much, Mr. Chairman.

I welcome you back, Danny. Welcome home to our committee. I welcome also Mr. Martin and Mr. White.

I know you're here to discuss the administration's plan to resolve the thrift crisis. I want to make very plain that I intend to do all I can to see that the legislation we produce basically does three things. One, produces the funds that are needed, the huge sums that are needed, in the fairest and most equitable and wise way possible. Second, that the legislation serves as a long-term thrift industry recovery vehicle; and finally, that the legislation assures that the thrift industry remains in housing finance where I believe it is very badly needed, particularly given the lack of affordable housing which is I think a serious family crisis and a social and economic crisis in our country at the present time.

I join Senator Garn in praising Chairman Don Riegle for the expeditious and skillful way in which he is handling this committee as it comes to grips with one of the most important matters that's ever come before this committee and I look forward to working under his leadership to help resolve this problem.

I do think we need to make some significant changes in the legislation as submitted by the administration. I have some questions, among other things, about the capital requirements under certain circumstances for certain institutions that meet certain standards. Although a majority of our banks and thrift institutions are in sound financial condition, a lack of confidence is evident in the system by the public and silent runs continue to ripple through the financial community. It's our duty to ensure that proper measures are taken since we are charged with maintaining the safety and soundness, along with the executive branch, of our financial system and we do intend to move swiftly and I hope wisely.

Danny, you stepped into a real hornet's nest when you left us and went to the Federal Home Loan Bank Board. I think you did your best with very limited resources at your disposal. They were too limited in my opinion. I look forward to hearing your comments on this proposal which puts you in the position of proceeding to help dismantle the very agency that you set out to run. I think your insights after a year as Chairman will be very helpful to us in our deliberations.

Thank you.

The CHAIRMAN. Thank you, Senator Cranston.

Senator Mack.

OPENING STATEMENT OF SENATOR MACK

Senator MACK. Thank you, Mr. Chairman.

And, Danny, welcome. I appreciate the opportunity to spend some time with you last week and look forward to your testimony. I, like Senator Cranston, do have a concern about what the industry is going to look like when we get through going through this transition period in the early 1990's and its impact on the ability to provide necessary funding for our housing market.

So I look forward to your testimony and I, too, want to compliment the chairman on how rapidly we're moving and I think we're going to come to a conclusion here probably by April and I look forward to your testimony.

The CHAIRMAN. Thank you, Senator Mack.

Senator Wirth.

OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. Thank you very much, Mr. Chairman. And once more, I thank you for continuing to push this along at this good rate. Mr. Wall, we thank you for being here.

I'd like to take a couple of minutes again this morning, if I might, Mr. Chairman, as I have in the past, to try to once again make sure that we are not drifting toward a partisan issue in any way, shape or form. There is plenty of blame to go around and I think that we on our side have to be very careful not to try to point fingers at the administration in its previous incarnation.

At the same time, I think that the other side has got to be enormously careful not to say that what happened was the result of congressional inaction because that is not the case either. There is plenty of blame to go around.

I think if we allow ourselves to get untracked—and I have noticed this beginning to pop up from time to time—if we allow ourselves to get untracked in a kind of partisan discussion of the issue, it is going to detract from our ability to, in a coherent way, develop what I think is going to be a bipartisan solution to the problem under the very able leadership of our new chairman, Senator Riegle. If we allow ourselves to get untracked, it seems to me, we then have the inherent opportunity for the press and observers of this to watch this as if it's a partisan battle rather than one of trying to sort out a very severe set of problems and come to some kind of solution.

There is plenty of evidence and plenty of statements that have been made. Those have all been put into the record on previous occasions—statements made by various senators that there was no more money that had to go into this, statements made by Mr. Wall and by Mr. Gould that no more money was needed to go into this, and those turned out to have been wrong at that point. Fine. There were mistakes made. We know that. But let's not get ourselves into a situation, Mr. Chairman, of worrying about who struck John. Let's continue to make sure that our efforts are focused on solving the problem.

I think you are doing that an doing that in a very able way, Mr. Chairman, and once again I thank you very much. I am going to continue to watch and listen to the testimony as carefully as I can, and when those kind of partisan items begin to rear their head again I'm going to start quoting from the record and the record is very clear. I think that's a very unnecessary and counter-productive approach for us to take.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Wirth.

Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman.

Mr. Wall, your name has been mentioned prominently in the course of the proceedings held by this committee. I am anxious to hear your testimony and anxious to have an opportunity to ask some questions of my own, so I will yield further time back, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Graham of Florida.

OPENING STATEMENT OF SENATOR GRAHAM

Senator GRAHAM. Mr. Chairman, I apologize for my late arrival and I hope that what I am going to say is not repetitive or interferes with the atmosphere of the meeting, but I believe that at this point candor is required.

Mr. Chairman, we are all aware that there is plenty of blame to go around as to why we have arrived at the circumstances we find ourselves in today.

However, part of the blame has to be focused on those who in the very recent past advised this committee and other congressional committees that we didn't have a problem and therefore discouraged any sense of urgency to get on with the job of working out the problem.

As one who has functioned both in the legislative and executive branches of Government, I know how important it is for one who represents the executive branch responsibilities to the legislature to accurately assess the condition and needs of that agency and assist the legislative branch in carrying out its independent legislative responsibility. This responsibility is the same as when one announces that peace is on the horizon whether placed in England in its ill-advised situation in the 1930's or placing this committee in the position of removing the sense of urgency to solve the savings and loan crisis. Executives should be aware of the consequences of their actions which their ungrounded optimism can engender.

Mr. Chairman, I would again like to bring to the committee's attention and to Mr. Wall his statement made on May 26, 1988 before this committee. On page 8, he stated:

> Together with deposit premiums and other resources available to us, that is FSLIC, these funds have enabled the FSLIC to begin resolving those cases on which it had previously been unable to act.

Moving to page 13, Mr. Wall continues:

> The Board projects that FSLIC possesses adequate resources in the near term to deal effectively with problem institutions in the thrift industry. This projection depends upon other segments of the thrift industry remaining stable and assumes no significant increase in interest rates or dramatic downturn in other sectors of the economy.

At that time Mr. Wall was projecting a cost to the fund of somewhere around $22.7 billion.

During the question and answer period with Senator Phil Gramm, Mr. Wall was asked:

> If we could avoid a taxpayer bailout.

Mr. Wall's response was:

> We believe that the numbers are such right now that barring any significant shift in our assumptions in the economy generally we are within striking distance of having dealt with all the problems with the resources available.

Senator Gramm then asked again:

> That you can avoid a taxpayer bailout, is that right?

Mr. Wall:

> We believe we have the resources available—that is, I say, to put us within striking distance of the problem barring any unforeseen shifts in the economy.

Mr. Wall, in his House testimony of September 8, at page 4, stated:

> I believe that in the past year FSLIC has made significant strides in resolving FSLIC cases and though subject to the vagaries of the future economic conditions realistic projections today indicate that FSLIC possesses adequate resources in the near term to deal effectively with the immediate problems of troubled institutions.

The problem was then estimated to be between $45 and $50 billion.

Mr. Chairman, I am troubled with this pattern of representation by Mr. Wall that has shown the situation to be so distant from what we now know to be the reality. His representations have contributed to an atmosphere of passivity while one of the most serious crisis in the financial history of our Nation went unattended.

As a fundamental goal of trying to avoid a repetition of this crisis, Mr. Wall is in a vantage position to advise us on the following questions and they should be addressed.

One, assuming that the statements made in May, September, and October reflect his true analysis of the savings and loan problem, why was his analysis so flawed and what recommendations to rectify these errors are being made?

Two, if the Federal Home Loan Bank Board had accurate data and if the suggestion that a conscientious effort was made to avoid telling us about the full extent of the problem until after the November election was made, I would be interested in any conversation with the administration and yourself relating to how this situation should have been presented to the American public. If this happened, why should we put the shredded independence of the Home Loan Bank Board under the Treasury?

Thank you.

The CHAIRMAN. Thank you, Senator Graham.

Senator Heinz and Senator Bond have joined us. I'm not sure which came first.

Senator HEINZ. For once, I think I may have gotten over the transom before Senator Bond.

The CHAIRMAN. Senator Heinz.

Senator BOND. It's a hard way to come in.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Nothing like Danny Wall moving to the Home Loan Bank Board 2 years ago when it was under water and sinking fast.

Danny, first let me welcome you back. It's a little bit like welcoming back the fellow who volunteered to become captain of the *Titanic* after it had hit the iceberg. I must say that in light of the number of S&L's that are in trouble in the industry we knew that you were going to spend a lot of time bailing out the thrifts and preventing the depositors from drowning. It needs to be said that when you got there I think that you found far too few lifeboats for all the depositors and that you've had to resort to using anything that floats. You've been getting a lot of criticism for doing that.

But the point is, when you inherited your captaincy of that ship you had no control over the number of lifeboats and you had no control over the number of life preservers in the locker. You had to do the best you could under the circumstances.

I do want to make a comment, though, that I think there is a lesson of the history of the *Titanic* that is very important to point out. The loss of life from the *Titanic* was among the third class passengers who were trapped below decks, the little people. Congress and the Federal Home Loan Bank Board and the Bush administration are coming first and foremost to the rescue of the little people. We are not here to rescue the people who own the cruise line. We are here to make sure that the depositors—every single depositor—comes out whole. And if the *Titanic* was lost because too many people went down with it, I think we need to make clear that not a single cent of insured deposits is going to be lost even though the FSLIC is currently sinking fast.

We in Congress have heard the SOS. The President has rushed to the scene with a strong plan. All depositors have been told that the financial safety that they have a right to expect is assured. The thrift industry is in the process of getting a new life preserver. That's the job of this committee. I want to emphasize that the owners and incompetent managers of the insolvent thrifts are going to go down with the ship, as indeed they should. To make this plan work effectively, we here in Congress have to act quickly and we should not forget that we are supposed to be planning an emergency rescue operation, not an analysis of what the course of the *Titanic* was over the last 15 years.

That means that we have to act to save the depositors and if we save money we will do it by saving time in acting.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

I was just looking through the testimony of Mr. Wall. I see in chart 1 that the various estimates by the various bodies of the thrift insolvency costs by the various bodies show that everybody has been low throughout and particularly those who were arguing for a $5 billion bailout in 1987.

Mr. Chairman, I've said all that I have to say about the thrift industry. I have no further metaphors to add, so I will wait for questions.

The CHAIRMAN. Thank you.

Senator D'Amato, did you want to make an initial comment?

Senator D'AMATO. Mr. Chairman, I'm just going to welcome Chairman Wall here and ask that my statement be included in the record as if read in its entirety, and save you all about 19 pages and 27 minutes.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, let me take this opportunity to both welcome Chairman Wall and to commend him for the service that he and his staff have done over the past 2 years. Danny Wall has been at the helm of a crippled ship in heavy seas. In perhaps no other area of Government over the past several years have so few done so much with so little. The Bank Board under Chairman Wall has undertaken a monumental task of stanching the flow of red ink in the hemorrahaging FSLIC. In 1988 they resolved over 200 failed thrifts and accomplished this despite insufficient resources, limited staff and a constant barrage of bad press and Monday morning quarterbacking.

Some may reasonably take exception to the details of particular FSLIC transactions or they may criticize the congressionally mandated scheme under which Chairman Wall's staff worked; however, no one can doubt their dedication and no one can question the Bank Board's resolve to do the best they could under difficult circumstances. Indeed, the Bank Board's 1988 efforts in the face of the FSLIC crisis remind me of that plucky pronouncement: the difficult we do immediately, the impossible takes a while longer.

Having said that, I will now take exception to a Bank Board proposal for the reconstituted Board of Freddie Mac. The Bank Board's proposal is too heavily weighted toward Government control. Only last summer this committee prompted the Bank Board to free the Freddie Mac stock so that private capital could flow into the thrift industry. The millions of dollars of new, real green money that flowed into the thrift industry through purchases of Freddie Mac preferred stock reflected the confidence of the capital markets in the future of Freddie Mac. The markets have also reacted to the Bank Board's Government-heavy board proposal and the reaction has been negative.

Even if the markets had not reacted, the right choice for a new Freddie Mac Board would be clear and clearly private in character. The Fannie Mae model is the best choice. The President appoints five members and the shareholders—the people who put up their own capital to support a competitive player in the secondary mortgage market—elect the remainder. This is also consistent with the purpose of Freddie Mac, to provide innovative and competitive secondary mortgage products in healthy competition with Fannie Mae.

Today, I and my colleague Senator Cranston, the chairman of the Housing Subcommittee, will introduce legislation to establish the new Freddie Mac Board with the same composition, authority, and treasury line of credit as Fannie Mae. I hope that this committee will include this sensible and market-oriented solution to the question of the future of Freddie Mac.

Thank you, Mr. Chairman.

The CHAIRMAN. We appreciate that.

Senator Dodd.

Senator DODD. I wish to welcome the gentlemen.

The CHAIRMAN. Thank you.

With that, Mr. Wall, accompanied by your two fellow board members, we are very pleased to have you before us today. We view your testimony as very important to our deliberations and we would like to hear from you now.

STATEMENT OF M. DANNY WALL, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD, ACCOMPANIED BY LAWRENCE J. WHITE AND ROGER F. MARTIN, BOARD MEMBERS

Mr. WALL. Thank you, Mr. Chairman and members of the committee. It is a pleasure to be with you today, and I will at the outset indicate that we have submitted a very extensive set of testimony. I would like to highlight some of the salient points in a review. I won't make the mistake of saying a quick review because I am afraid it will be a little bit more than I would like to have taken in terms of time. But there clearly are many issues and many points that need to be highlighted from the substantive testimony. I think I will respond very directly to some of the points that have been raised by you already as members of the committee, and will also begin the discussion which I'm sure will be pursued with additional questions.

Let me say first of all that we have indeed been making progress toward resolving the problems of the industry with, as has been said in many different ways this morning, insufficient resources—insufficient resources both human and financial—but we have been making progress.

We liquidated in 1988 26 institutions, and of course liquidations are big cash users. We merged and/or sold 179 institutions, for a total of 205 institutions in 1988 with 21 in 1987. I call your attention to exhibit No. 1. It demonstrates very graphically how last year's activity relates to the previous several years level of activity and obviously an astonishing difference in scale as we began to put under our belt the problem institutions.

The second chart on exhibit 1 demonstrates very clearly that we have turned the corner as far as GAP insolvencies, where years previously they continued to increase even with the case resolutions that were being carried out. We have seen now a significant reduction in the number of GAP insolvencies and that number will continue to be reduced as the programs that are being talked about are made available.

There are many long-standing insolvencies, as demonstrated by exhibit No. 2, some going back as far as 10 years. It's been said already this morning that the losses by those 205 institutions that we dealt with last year would, in an operating sense, have represented an additional $4.2 billion of losses in 1989.

What are we doing to be sure the problem will never happen again? In a very real sense, I'm glad you asked. We have strengthened the staff from top to bottom, without question. We have redoubled our efforts to improve the regulatory and supervisory apparatus in the Bank Board as well as in the district banks. We have put into place a comprehensive structure to more readily identify and react to problems more quickly.

As an example, although the district bank in Dallas is seeing fewer and fewer institutions because of consolidations and because of failures, both in the State of Texas and the other four States within the district they are hiring an additional 120 examiners. They are, in some of the consolidations, seeing institutions that are larger than before, albeit fewer of them. Indeed the industry is becoming far, far more sophisticated than has been the case in the past.

We have doubled the regulatory staff in 3 years, have enhanced training and education, and have conducted more frequent and better examinations. In that sense, we are ahead of the bank regulatory agencies. We have put back into place a package of regulatory handbooks, something that had been at the Bank Board back in the early 1970's, the watchword of the examination force of all of the bank and financial institution regulatory agencies. It fell into disuse. We have now put it back into place with seven different handbooks providing for the categorical distinctions appropriate thereto.

We have a regulatory plan format that is custom designed for each institution. We have put into place regulations dealing with asset growth limitations, equity risk investments, high yield—junk bond—restrictions, mortgage derivative restrictions, and interest rate risk management provisions. We also have conducted 2 days of hearings on the proposed risk-based capital regulation—that is to say, putting into place the Basil risk-based capital accord for commercial banks and adding to it what we think is a very important interest rate risk component. We have, as well, a related early intervention proposal as far as regulation is concerned which would explicitly give us the authority to step in at 1.5 percent of GAP capital and take an earlier action. Previously we were limited to waiting for RAP insolvency to occur to take action.

All of this effort is because we believe that a healthy thrift industry is a critical part of the financial services industry. We have removed deeply troubled institutions, and, as we do, the sound sector of the industry gets bigger and bigger in a very rapid way.

At the end of 1987, 83 percent of the institutions by number were solvent, holding 85 percent of the assets. By the end of 1988, 88 percent of the institutions by number were solvent, holding in excess of 90 percent of the assets of the industry.

What relevant policy issues are there still facing the Nation? Clearly, we have to put the rest of the problem under contract, and we have to move forward in getting those insolvent institutions out of the unfair competitive position in which we find them.

The President's bold and comprehensive plan, which we support, will do just that. It provides the resources necessary to resolve the remaining troubled thrifts in financial and in human terms. Our actions helped to contain the problem in the interim but that's all that we were able to do—to contain the problem and to begin to make some headway against the GAP insolvencies. To delay further costs money. It costs money literally every day.

The President's plan provides financial stability and a sound Federal deposit insurance system. The premium structure, which must be part of the balance, also provides for the resources necessary to build the future fund—in the case of the bank sector a healthier fund and in the case of the thrift industry a fund that would be recapitalized in its entirety. It must provide for the rate difficulties, and that is the kind of thing that we are experiencing today. And I'll reference you to appendix A for your, and certainly your staff's review, where we have made an assessment and analysis of the first 2 years of deposit insurance. Initially deposit insurance premiums were 25 basis points, ¼ of 1 percent, in 1933 when the deposit insurance system was put into place for both banks and thrifts.

The Congress gave the assignment to the first FDIC chairman to go out with actuaries and make an analysis of what the losses were and what the premiums would have had to have been since the signing of the National Bank Act in 1863 until 1933—what the losses were and what the premiums would have needed to have been to have dealt with those problems.

The actuaries and the FDIC chairman came back and said 25 basis points isn't enough. It needs to be 32 basis points. And Congress in 1934 said, "Thank you very much," and established the premium at 1/12th of 1 percent, 8.3 basis points, 1/4 of what the actuaries told the Congress in 1934 would be necessary to cover the three characteristics of insurance losses—normal, abnormal, and catastrophic.

What the 1/12th of 1 percent was established as the amount of premium necessary to cover the normal losses. Wonder of wonders, the Congress and the government of the United States was lucky because the actuary was wrong. The actuary didn't think that that level of premium would cover the abnormal losses, but indeed that has been the case. But it clearly wasn't enough to cover the catastrophic losses, and that's what we're looking at now, without question.

So that has to be provided for and there has to be an explicit mechanism providing for the ability on some kind of an experiencial basis for the insurance entity to access more resources. That's what the President's program proposes and provides for.

It also provides for a separate regulatory entity which must have the same latitude as the Office of the Comptroller of the Currency. To give it less—or to leave more with the FDIC or the surviving insurance entity—is to put the thrift industry and its regulator at a disadvantage as far as the going forward and opportunities of the industry is concerned.

We have to have the enforcement ability in a regulatory and supervisory sense on a par with other entities, as the OCC does, as far as those other entities—the insurer being the particular one.

We have to have the chartering authority in terms of the powers, the question of whether or not States' authorities, which would be within our jurisdiction as the regulator. We must have the ability to deal with those in a real sense.

We also must have a realistic capital-setting authority on the upside as well as on the downside.

Then, Mr. Chairman, responding directly to some of the specific questions that you have posed—how big is the problem? I would call your attention to chart No. 1, to which Senator Bond has already referenced. Everybody has been underestimating the size of the problem. In that sense, we are in good company. There has, without question, been an increase of the size of the estimate of the problem. And why? Because there had been—fortunately, for the most part it appears that is now no longer the case—an absolute disaster in the real estate economy in the State of Texas.

When I was before this committee last year early in the year, I made observations that the Texas problem was about half of our problem. Wrong. It's now 60 percent of our problem. As the problem has gotten bigger, disproportionately the problem is in Texas in terms of the institutions. But don't make the mistake that some make of thinking that, all right, the other institutions elsewhere in the country have some other problem. Typically, the institutions elsewhere in the country have Texas assets problems that have caused their problem.

You may have heard the observation made—many of you, at least I do, go by it every day on the way to work—the former McLean Savings in McLean was a Texas S&L physically domiciled in the suburbs of McLean, VA. Indeed, very much a lender, very much a player in the Texas market and devastated as a result.

In 1986 the Congress itself said $15 billion was enough. Then in 1987 they said $5, $7.5, $8.5, billion then up to $10.825 billion that was going to be a downpayment to the problem. They never said, nor have we, that was enough. Moreover, $3.75 billion was established by Congress as an annual borrowing limit, curtailing the use of that $10.825 billion.

CEBA also mandated us to provide for phasing out the special assessment in 5 years. The first thing that I dealt with, and had to anguish over, as far as the question of insurance premiums and insurance resources was whether or not at the end of September 1987 to begin that phase-out which Congress had designated—"unless". I made the finding that "unless" was the case, and we had to continue the special assessment.

All of these are just estimates. That's all anyone can do is estimate. The Chairman of the Federal Reserve made that observation the other day, as I understand it, in a very articulate way. Even when we have the contractor on the other side of the table with whom we are moving forward in a 10 or a 5 year contractual relationship, they are still just estimates. They are better estimates because there's somebody else who's making the assessment of what the cost of that case is going to be, but it's still an estimate.

When I got to the Board on July 1, 1987, there was no methodology, no procedure, for estimating the size of the problem. There were numbers that had been quoted before, but they were simply numbers taken out of the air.

In the spring of 1988 when I reported to this committee on the basis of September 30 data from the previous year that it was a $22.7 billion estimate, I said that would require not phasing out the special assessment but in fact extending it for 8 years. In July 1988 when we used year-end 1987 data and new data on the problem in Texas, the increased estimate at that point was then $30.9 billion, I said again, rather than phasing out the special assessment, it must be extended to not just 8 years, but then 10 years.

Then in October of last year, when I reported to the Senate Budget Committee using June 30 data from 1988 that the size of the problem was $45 to $50 billion, I said that the special assessments then had to be extended for up to 30 years. I further said that that's not realistic.

As we were nearing the end of this year, we saw that we would have an additional amount of information on the cases under contract. So as to benefit from this, we assigned to the district banks the assignment of the examiners and the supervisors, on a case-by-case basis, to go through an extensive worksheet program to make a writeup for each institution as to what they thought the cost of the resolution would be. On this building block, we have put together a new estimate—again, since there's a lag in this data being available—using September 30, 1988 data. In January, we announced that our estimate was $75 to $80 billion and that basically means the permanent establishment of the special assessment or a Presidential proposal to be dealt with as far as the Congress is concerned, which is indeed what has come forward. You can look on table 1 for more data.

In 1988, a $38 billion portion of the problem that we put under contract has been done with. We have preserved and maintained for the Congress and the administration and for our agency—and/or the FDIC if they get this assignment—a maximum amount of flexibility to deal with those contracts. I mean not renegotiating the contracts as some have lightly suggested or might have postured, but in fact the ability to play those contracts like a piano: The ability to buy out assets, the ability to buy down notes, the ability to do many things within the contract and within the contract obligation that exists.

I am not a lawyer, but one of the brightest lawyers that I've encountered made the observation that if you're in a contractual relationship and you control the checkbook and on the other hand the provisions are general and not specific, you are in control of that contract. And that's precisely where the FSLIC has put the Government. We are in control of the checkbook, and we have general provisions which can be exercised and can be adjusted and can be focused by our attention and by our direction.

There are those opportunities to modify the transactions in every way, but we must have the resources in order to provide for and in order to deal with those contracts in a realistic way. And the rest of the problem has to be dealt with as well. We can't simply stop. Clearly I don't want to overstate it, because I don't sense that anyone is. But I would remind you, having put—as the chairman indicated—under contract nearly half of the problem by the current estimate, it is clearly important that we continue to make the progress and not lose the headway.

In 1988 transactions we have—if you want to deal with the specifics, we clearly will provide that and do that at your request—brought into the thrift industry in this country $3 billion of capital. $3 billion of capital that wasn't there on January 1, 1988 was there on January 1 1989; $1.1 billion of capital in the State of Texas alone in the face of an economy that, at that point, not everyone was convinced had even hit bottom, and we were able to get that new capital in. So that in a very real sense we have gotten underway a new attitude as far as investors are concerned.

Yes, some of them are entrepreneurial in their approach and in their records because that is the kind of investor who is willing to put the money in, given we don't have the full faith and credit for FSLIC notes on the one hand and don't have the cash on the other hand to use in its place.

Some would say more liquidations might be the course of action over time if the dollars are available. But you have to have all of the dollars for the insured deposits on day one to do a liquidation. You can't send the depositor a note saying we will pay you in a year when Congress gives us some cash. You have to pay the cash amount of that deposit on the date of the payout that would be proposed in a liquidation.

So in a very real sense liquidation wasn't an alternative last year. The only alternative to not moving forward with the mergers and the sales that we had was no action, which we saw as no alternative at all.

How should the cost of dealing with the problem be financed? Without question, this is the most profound public policy question that you are going to be dealing with as the Congress. Many have benefited from the industry over the years: The home buyers, the home builders, the real estate industry, the building suppliers. And the list goes on and on. But there are some areas where there have been benefits as well that people don't think about. One of them is the depositors. Depositors in the last few years have been receiving more interest on insured deposits than they should have been because of the questions that were in the marketplace under the banner of what has come to be known as the Texas premium.

The thrift industry is clearly not solely to blame. As has been said here already, there is plenty of blame to go around, and there are plenty of different sectors where blame can be assessed. You can talk about the late 1970's monetary policy changes. You can talk about interest rate deregulation in 1980 by the Congress and by the administration at that time, putting into place liability deregulation with insufficient asset opportunities to make the additional money with which to pay those higher interest rates. Without question inadequate supervision at the State and Federal level was a problem—no question about it. It was inadequate, and in some cases staffs were insufficiently paid and in most cases far too inexperienced.

In the early 1980's, the Federal Home Loan Bank Board did authorize and permit capital reduction at a time when the interest rate spread problem was seen as manageable, with a reduction in capital simply providing for additional time for the problem to turn itself around.

And, of course, we had an energy boom situation that turned a real estate market in the Southwestern part of this country, together with a positive or an incentive oriented tax code, absolutely on fire in the positive sense. It was just going gangbusters. And then, of course, the energy bust occurred and you saw the real estate market deteriorating literally in front of your eyes. And then that was further aided and abetted by the 1986 tax act which provided insufficient transition provisions as far as the real estate economy was concerned. So it was a double whammy.

The situation of the CEBA recapitalization——

The CHAIRMAN. Let me just interrupt here for a minute because this is a very important look at the history. It's important that we have those in the record. But let me also indicate that I want to make sure that we leave enough time for questions. We've got very good participation by the committee this morning, and I know a number of people have questions that they want to ask. We are profoundly interested in your reaction to the plan in large detail and small detail, and I don't want to have our time get away from us and not get to the exchange that I think is really terribly important. I know you want to have that occur as well.

Let me make this suggestion. What I'd like to have you do in an orderly way is move into the issue of your specific reaction to the plan, any parts that you think need to be more fully considered or perhaps adjusted in one dimension or another. We've had other regulators come before us. We had Bill Seidman and as you know he had some observations to make, as did the Comptroller of the Currency. But without wanting to break the flow of your presentation, I do think it's important that we proceed in a fashion where we get to the point of letting us hear your thoughts on the plan itself and where perhaps it needs to be adjusted as you would see it.

Mr. WALL. Well, my timing was pretty good but not quite. I was just there now, Senator, and I will proceed if I might. I still haven't used as much time as the Senators did.

The CHAIRMAN. If you get elected to the Senate, then you can.

Mr. WALL. No question about it, this is a hearing.

The industry has borne the cost thus far. Without question, the special assessments as I referred to it, as well as the Federal Home Loan Bank contributions, which are continued in the President's package. And I think it is an appropriate way for the President's package to be constructed.

The President's plan provides appropriately for a sharing, a sharing between the industry itself, which currently shoulders all of the obligation and all of the responsibility, and the Federal Government and its resources which of course are the taxpayer.

The viability of the industry I think is clearly there. There are a number of charts that provide for that and in that sense I don't need to remind you. I think this committee clearly is familiar and supportive of the industry and its future prospects and that is why we are here and dealing with the question.

I think in a very real sense the overall balance of the higher premiums versus the higher capital requirements and the offsetting depositor and investor attitudes, as they are changing, must be considered and weighed carefully. That is, the extent to which more capital is being required and higher premiums are being required on the industry side, some of that will be offset by the prospect of this Texas premium continuing to shrink. We were able to make significant headway against the Texas premium last year, but there still is a margin there that can be eliminated. As there indeed are more costs to be assessed on the industry which to continue to be the industry's obligation, there is the prospect for those costs to be offset by some of these savings on their cost of funds.

In a very real sense the industry continues to be a real estate lender and a portfolio repository of real estate obligations; 38 percent of all of the total residential real estate obligations for a total of nearly $800 billion of paper is held by the thrift industry.

There are many provisions as far as the regulatory restructuring of the agency in the proposed legislation, and I think we'll get to them probably in a real sense as far as the questions and answers are concerned. I think, as I've said already, we must preserve the structure that permits the agency—wherever and however it's functioning—to be a real agency with the authority necessary and concomitant to its functions and responsibilities. We must preserve in a real sense the structure in place for examinations and supervision that is now finally at the level of competence and expertise that it should have been all of these years when all of these other things were having the very huge impact on what was going on as far as the industry is concerned.

Banks and thrifts, while they may appear to have similar kinds of powers, have portfolios that are not in the least alike. There are many charts and I would refer you specifically to chart No. 12 as a way of identifying what is in the portfolio of a bank versus what is in the portfolio of a thrift institution.

The housing finance orientation is a different kind of risk exposure on the part of the thrift institutions. They have a longer-term interest rate exposure. There are different investment strategies and different regulatory and supervisory problems.

There is an expanded range of asset diversification that has to be available to the industry and has to be used prudently. It is more and more available, but there was not sufficient prudent use of those opportunities.

Having said all of this, a couple of recommendations that I'd like to make that I don't think have had much attention that might be a little bit surprising to some. While the risk characteristics of banks and thrifts necessitate separate regulatory structures, community orientation of small banks may justify their participation in such programs as access to the Federal Home Loan Bank advances and other services provided by the Federal Home Loan Bank. We would hope that the Congress would consider the possibility of bank access for borrowing from and possibly even membership in Federal Home Loan Banks by the commercial banks. I think it is an opportunity for expansion of what products and services those smaller banks can provide in their local communities.

Much of what remains to be done—and there is much to do, obviously—can only be accomplished if the Congress is willing to move forward. You need to provide the resources to permit us to deal with the remaining troubled thrifts and to continue to implement regulatory and supervisory changes that ensure the continued viability of the healthy segment of the industry.

Mr. Chairman, I'd be happy to respond to your questions and, as you said, I am accompanied by my two colleagues.

[The complete prepared statement of M. Danny Wall follows:]

STATEMENT OF

M. DANNY WALL, CHAIRMAN

FEDERAL HOME LOAN BANK BOARD

Mr. Chairman and members of the Committee, I am pleased to appear before you today. I will begin my testimony by reviewing the progress that we have made toward resolving the problems of the thrift industry. I will then comment on the relevant policy issues still facing the nation and conclude by responding in detail to the specific questions that you asked me to address.

The Federal Home Loan Bank Board (Bank Board) has devoted all its energies since I assumed the Chairmanship in July of 1987 to two main tasks. The first was to bring the current problems of the industry under control by liquidating or merging as many troubled institutions as our human and financial resources permitted. As a result, more than 200 troubled institutions were resolved during the past year alone (see Exhibit 1). These thrifts had been in trouble for years (see Exhibit 2) and were incurring losses every day no action was taken. Had we not taken action to resolve these institutions, they would have incurred over $4 billion of further operating losses this year. This would have simply added to the total bill the Federal Savings and Loan Insurance Corporation (FSLIC) would have eventually been obligated to pay. Moreover, the large number of resolutions generated substantial spillover benefits to the entire thrift industry. The premium that healthy thrifts had been forced to pay for deposits has been reduced significantly during the past year, as insolvent institutions were removed and no longer could bid up deposit rates.

The second and concurrent task was to be sure that the same problem will never happen again. We, therefore, strengthened our staff from top-to-bottom and redoubled our efforts to improve the regulatory and supervisory apparatus. We have put in place a comprehensive new structure that can more readily identify and react to problems in a more timely manner. The regulatory staff has almost doubled in the past three years, drawing upon experienced personnel from throughout the federal government and elsewhere. The training and education of examiners has been significantly enhanced. We have also increased the frequency and quality of thrift examinations. Moreover, regulatory handbooks were recently prepared and distributed to examiners, supervisors, and thrift management to ensure thorough and consistent examinations. Regulatory procedures have been revamped so that a customized regulatory plan can be formulated to address each and every institution's areas of vulnerability.

Regulatory actions we have recently taken are aimed at potential problem areas that thrift institutions may encounter in the future. We have limited the asset growth of troubled institutions and adopted strict guidelines for equity-risk investments and high-yield ("junk") bonds. Finally, we have just proposed the most comprehensive risk-based capital regulation in

existence at any regulatory agency. An accompanying early-intervention proposal would provide for speedier action against thrifts experiencing an eroding capital base.

We have engaged in these tasks because we believe that a healthy thrift industry is a critical part of today's--and tomorrow's--financial services industry. Once the deeply troubled institutions are removed from the industry, data indicate that most of the remaining thrifts are financially sound. They are earning profits and attracting capital. These institutions--who are primarily providing funds for housing--are the institutions one must focus on to assess the future of the industry. Healthy thrift institutions perform a uniquely vital and stable role in our housing finance system. While this long-standing role has evolved with the development of secondary mortgage markets, thrift institutions are still the largest originator and the major holder of residential mortgages.

Having spent the past twenty months resolving troubled thrifts and establishing an improved regulatory framework for healthy thrifts, we believe that the President has proposed a bold and comprehensive plan that contains the necessary elements to complete the job that we have started. Three points should be emphasized. First, the plan provides for the resources needed to resolve the remaining troubled thrifts. Our actions have helped contain the problem. However, every day that we delay, the costs only go higher. I will discuss the issues of how much it will cost and who should bear this cost, as you requested, below.

The second important point is that the President's plan provides for financial stability and a sound federal deposit insurance system. The proposed new premium structure not only helps pay for the current problem, but it will also build a strong insurance fund for the future. An insurance premium structure must be designed to provide adequate resources to meet the difficulties deposit insurance funds may face on rare occasions; the lack of such a structure was a major design flaw in the current system that must be corrected.

Third, as the plan works its way through the legislative process we must remember the importance of the thrift industry in the housing finance system and the need for a separate regulatory agency for the industry. The new Federal Home Loan Bank System must be empowered to continue the task of regulating and supervising the industry. The chartering authority must be flexible and strong enough to permit thrift institutions to continue serving our nation's housing needs while simultaneously diversifying to an appropriate degree into related activities. But this implies that the Bank System must have the same latitude and discretion to regulate thrift institutions as the Comptroller of the Currency has with respect to national banks. Finally, we must be permitted to continue our efforts to implement, over a reasonable time period, an effective capital regulation that ensures the future safety and soundness of thrift institutions.

I will now turn to your questions concerning the cost of resolving troubled thrifts, who should bear this cost, the viability of thrift institutions, and the regulatory and structural changes needed to prevent a recurrence of the current problem.

HOW BIG IS THE PROBLEM?

The Bank Board has been criticized for revising upward its estimate of the amount of funds needed by the FSLIC. While I fully accept that criticism, in all fairness it must be pointed out that the Bank Board has not been alone in that regard. Many private analysts and other government agencies have also revised their estimates upward (see Chart 1). Indeed, the General Accounting Office (GAO) increased its estimate by $46 billion between May 1988 and January 1989. Even private analysts have increased their estimates over the last two years by more than $50 billion.

Difficulties in assessing the magnitude of the problem are not new. Even before I came to the Bank Board, considerable disagreement existed about the funds needed as the Congress considered the Recapitalization Plan for the FSLIC. In 1986, the Senate and the House each passed $15 billion recapitalization bills that went unreconciled. In 1987, the Reagan Administration proposed a $15 billion plan, whereas the industry argued that only $5 billion was needed. Considerable differences of opinion also were evident that year in Congress. Although the Senate's recapitalization bill in 1987 provided for $7.5 billion in borrowing authority for the FSLIC, two earlier attempts to expand this authority had been defeated in the Senate Banking Committee. The House, during the same session, passed a $5 billion package after several attempts to raise the borrowing authority were defeated. House supporters of the $5 billion plan argued that the Congress would have to revisit the issue in two years anyway, since no one knew exactly how much would be needed.

The conference committee agreed on a bill that included $8.5 billion, despite reported general agreement that this amount would be insufficient. The White House announced that it would veto the conference bill because President Reagan wanted greater FSLIC borrowing authority. Treasury Secretary Baker intervened, and a compromise bill was passed by the Congress providing $10.825 billion, but which limited borrowings to $3.75 billion per year.

What all this points out is that all estimates of the cost of resolving the thrift problem are just that--estimates based on differing methodologies and assumptions about future financial conditions as well as the length of time over which actions are taken. They are, therefore, susceptible to revision when relevant, new information becomes available. Much of the needed information can be obtained only as insolvent institutions are actually resolved or after institutions have filed their financial reports. The estimates must also be revised in response to changes in interest rates and regional economic conditions. Such changes affect the value of thrift assets and, therefore, the cost of resolving troubled thrifts.

Past Cost Estimates. Shortly after coming to the Bank Board in mid-1987, I discovered that there was no formal method in place for estimating the costs of resolving troubled thrifts. Therefore, the FSLIC, in cooperation with the GAO (our auditor), other Bank Board offices, and the District Bank supervisory personnel, developed a method for estimating the potential costs strictly in accordance with generally accepted accounting principles (GAAP). The estimates were based on current accounting principles as they relate to "estimable and probable losses." This method does not necessarily recognize all potential losses implied by current market conditions, but instead relies on historically based accounting values for most assets. Furthermore, only those institutions that were GAAP-insolvent were included in the estimates.

Despite its limitations, this method was determined by the Bank Board and the GAO to be an acceptable approach for assessing the financial condition of the FSLIC. At the time, the FSLIC did not have adequate data based on actual experience in case resolutions to use as an alternative.

The year-end 1987 estimate of $22.7 billion for the cost of resolving troubled thrifts represented our best effort based upon these generally accepted accounting principles using September 1987 data. The estimate included costs for resolving all institutions in the FSLIC caseload, those in the Southwest Plan, and all other GAAP-insolvent institutions. Our year-end 1987 estimate suggested that the special assessment on thrifts would have to be continued for almost eight years.

In July 1988, the FSLIC issued detailed cash flow projections for the next 10 years based upon estimates of future resources and case-resolution costs. As for the earlier and subsequent estimates, the need to continue the special assessment years into the future formed the basis for these cash flow projections because it was the only way the FSLIC could effectively obtain additional revenues, despite the Competitive Equality Banking Act's (CEBA) provision for a potential phase-out of this assessment. Specifically, at that date, we concluded that the special assessment would have to be extended to at least ten years. During the preparation of these cash flows, we were able to analyze fourth-quarter 1987 financial data reported by individual thrifts and the actual resolution costs of early Southwest Plan cases. Based upon this new information, we reassessed the estimates made a few months earlier that had relied on September 1987 data. The newly available data showed a sharper-than-expected pattern of asset write-downs in the southwest and, thus, a need to raise our cost estimate, as well as to extend the special assessment. Accordingly, we included an additional $8.2 billion for the Southwest Plan and revised our total cost estimate upward to $30.9 billion. Experience at that time in other parts of the country did not indicate a need to alter our estimates for cases outside the southwest.

In October of 1988, the FSLIC once again updated its estimate based on information from a large number of additional resolution actions and from the June 1988 financial data. This analysis included 419 unresolved institutions that were judged likely to require FSLIC financial assistance in the future. For 67 of the 419 institutions where an acquirer had already proposed terms for a merger, the FSLIC estimated the cost of resolution based upon these terms. The remaining institutions for which bids were not available were costed at a multiple of their negative tangible net worth as reported on June 30, 1988, with the exact multiple reflecting our resolution experience through the end of the third quarter. This methodology is basically the same as that used recently by Mr. Frederick Wolf of GAO.

The revised estimate suggested that the cost for the resolution of future FSLIC cases would range from $24.9 billion to $29.9 billion. To these figures was added the estimated $20 billion in FSLIC notes and guarantees under assistance agreements for those cases that had already been resolved. This yielded a present-value estimate ranging between $45 billion and $50 billion. It should be noted, at that time, we once again extended the length of time--to 30 years--over which we believed the special assessment would have to be levied to meet our new and higher estimate.

A New Look at the Size of the Problem. Given our limited experience in determining the value of troubled thrifts' assets, our estimates on earlier occasions were purposely tied to known historical data and to institutions in demonstrable difficulty because they were already insolvent. It must be noted that--unlike most outside analysts who have the luxury of speculative analysis--we felt the obligation to base our estimates on a full analysis of the actual resolution experience and on the expertise of District Bank supervisory personnel. By definition, however, the historically based accounting procedures upon which we have relied lag the realities of the market place. Even when we updated our estimates based upon more recent resolution experience, the estimates considered future resource needs based on only then-insolvent institutions. It was not until this past October, when I felt we had accumulated sufficient experience, that I instructed the FSLIC and the supervisory staff at the District Banks to go beyond the strict

accounting approach. I felt this expanded view of the problem would now be appropriate in light of our increased knowledge and experience.

To develop such an estimate, all institutions that, as of December 31, 1988, might impose costs upon the FSLIC were identified. Thus, solvent but thinly capitalized institutions were included in this broader estimate. (As our numbers will show, some of the institutions originally identified were ultimately determined unlikely to impose financial costs on the FSLIC.) The supervisory personnel from the District Banks--those most familiar with the institutions and their assets--did a case-by-case review of the assets of these institutions to identify specific sources of the potential losses. Where possible, appraisals were used. If recent appraisals were not available, other supporting documentation was requested. In addition to the estimated losses due to asset-quality problems, market-value losses due to interest-rate changes were included. With this change in methodology in mind, the Bank Board has now arrived at what we believe to be the most comprehensive estimate of the resources necessary to resolve problem institutions. As is the case--and has been the case for all previous estimates--the ultimate cost of resolution could be either lower or higher depending on future asset values as determined by the course of economic developments and by the path of interest rates. It will also, of course, be higher due to any failure to act in a decisive and timely manner.

The numbers we are reporting are present-value numbers based on September 30, 1988 financial data. They encompass both deals already concluded in calendar year 1988 and a very broad range of troubled thrifts that had not been resolved by December 31, 1988. They include all 109 institutions in the FSLIC caseload as of December 31, 1988, 69 insolvent Southwest Plan institutions, and 153 additional GAAP-insolvent institutions. Of special note is the inclusion of 247 GAAP-solvent institutions that were identified by supervisory personnel as likely future FSLIC cases. This is a major departure from past procedures.

Based on this group of institutions and financial data available through September 1988, the Bank Board estimates that as of December 31, 1988, the cost for resolving troubled thrifts is between $75 billion and $80 billion. Included are $38 billion for cases not yet resolved (see Table 1) and $38 billion for cases acted upon during calendar year 1988.

Let me point out that the $38 billion estimate for the cost of transactions during 1988 is subject to an extremely important caveat. In arranging most of the mergers, the Bank Board sought to retain for the Administration and the Congress the maximum flexibility possible to modify the transactions. For virtually all institutions resolved in 1988 for which yield maintenance or capital loss coverage were provided, FSLIC retained a "call" option. That is to say, the FSLIC can repurchase the assets from

Table 1
Estimated Cost as of December 1988 for
Resolving Remaining Troubled Thrifts
(Based on September 1988 Data)

Status of Institutions	Number	Assets ($ Billions)	Net Worth ($ Billions)	Estimated Resolution Cost ($ Billions)
GAAP Insolvent*				
FSLIC Cases	109	23.0	-5.0	7.3
Southwest Plan Cases	69	26.5	-5.7	12.8
Other	85	28.6	-1.5	3.9
No Cost Expected	68	16.0	-0.5	0.0
GAAP Solvent--Troubled				
Non-Southwest	70	91.8	-1.3	9.1
Southwest Plan Cases	54	17.7	-.1	4.9
No Cost Expected	123	66.7	-0.3	0.0
Total	578	207.3	-14.4	38.0

* Institutions that were identified GAAP insolvent as of September 30, 1988. During the Fourth Quarter of 1988, additional institutions listed as GAAP solvent but troubled may have also moved into this category.

the acquirer and eliminate future payments. Similarly, more than 70 percent of FSLIC notes outstanding can be recalled at any time. Almost all of the remaining notes have some call features. If changing interest rates make the use of these notes relatively more costly than an alternative source of funds, they can be restructured.

The President's plan provides for $90 billion to address the crisis in the thrift industry. This amount is in line with our estimate of how much is needed to cover the FSLIC's liabilities. Additionally, resources would be made available to place the thrift deposit insurance fund (the Savings Association Insurance Fund) on a sound financial basis for the future. Finally, the President's plan would enable the insuring agency to begin to act immediately against still-operating but troubled institutions. Based on our experience, it cannot be emphasized strongly enough how important additional funding is to prevent further escalation in resolution costs.

Recent Transactions. The Bank Board has sought to resolve troubled institutions in the most cost-effective manner possible. At the same time, as I will discuss below, we have maintained maximum flexibility for future Administration or congressional action. Reviews of our most recent transactions are currently being conducted by the GAO and by independent experts, as requested by this committee.

Since I have discussed the December 1988 FSLIC transactions at length in previous testimony, I will keep my comments brief. The December mergers have been criticized on various grounds: yield maintenance and capital loss coverage were included, the tax benefits were too large, or the FSLIC failed to attract sufficient new capital or new management. Such criticism misses several important points, however. First, tax benefits are merely one form of compensation to an acquirer. If tax benefits were not part of the package, the FSLIC would have had to increase other payments to the acquirers to compensate them for accepting the "bad" assets already on the books of the insolvent institutions. Thus, when tax benefits are realized, the FSLIC captures a share of the value of the tax benefits.

The criticisms concerning the FSLIC's failure to attract new capital and new management are also unfounded. In 1988, $3 billion of capital was committed to the thrift industry as a result of FSLIC actions. This included over $1 billion from Southwest Plan transactions. Similarly, a wide range of new acquirers with significant new management capabilities was attracted to the industry. Of the 179 assisted acquisitions in 1988, over half involved acquirers from outside the thrift and banking industries.

Finally, some have suggested that the FSLIC should have liquidated more institutions, given the difficulty of including the proper incentives in asset management contracts in merger agreements. In light of the FSLIC's limited cash resources, however, liquidation was not an alternative in most transactions. The only realistic alternative to the transaction was to allow the insolvent thrift to continue to operate. But this often means higher costs to the FSLIC in the future. Moreover, unless all assets are "dumped" on the market at once, incentive problems are not avoided in liquidations either. When an institution is liquidated, the FSLIC takes control of the institution's assets. Management and the ultimate disposition of those assets is usually contracted out. The same problems of incentives must be faced with agents under a liquidation as with an acquirer who is performing the same task for the FSLIC.

HOW SHOULD THE COST OF DEALING WITH THE PROBLEM BE FINANCED?

Exactly how the cost of dealing with the troubled segment of the thrift industry is to be borne remains ahead of us. Let me make several points. Many elements of society have benefited from the existence of the thrift industry over the years. Moreover, the current crisis is not solely the fault of the industry--particularly the remaining healthy thrift institutions. These facts suggest that a plan such as the one the President has proposed, in which the burden is shared by the industry and by the public in general, is appropriate.

Many Have Benefited. The current federal deposit insurance system was not designed to be self-funding, as an insurance plan in the private sector would be structured. The premiums levied were not meant to cover a crisis of the magnitude we are now facing, nor was there a specific plan as to how insured deposits would be covered in such an event. If a plan had existed, we would not now be discussing who should bear this cost. In addition, the federal insurance system could not be selective as to which institutions it would insure to minimize its risk exposure. Thus, the system was more a government guarantee program than a fully funded insurance system. A detailed discussion of this issue is provided in James R. Barth, John J. Feid, Gabriel Riedel, and M. Hampton Tunis, "Alternative Federal Deposit Insurance Regimes," Research Paper #152, Office of Policy and Economic Research, Federal Home Loan Bank Board, January 1989 (see Appendix A).

The historically low premiums and financial stability associated with deposit insurance have benefited many elements of society. It certainly encouraged the growth of the thrift industry. However, homebuyers also benefited, as the low premiums were at least partially reflected in lower mortgage rates. This, in turn, helped the homebuilders, realtors, and all the other industries directly or indirectly related to housing the American family. Furthermore, many depositors have put their money in insolvent institutions solely to earn above-market interest rates. In Texas institutions alone, such depositors

have earned several billion dollars in "excess returns" during the 1980s. Thus, it seems only fair that some of the burden be borne by those who benefited over the years.

The Thrift Industry Was Not Solely to Blame. The thrift industry has been buffeted by changes during the past several years over which it had little control. Like other interest-sensitive sectors of the economy, thrifts bore a disproportionate share of the burden of monetary policy actions to fight inflation. The Federal Reserve Board changed the focus of monetary policy in October 1979, which contributed to an unprecedented increase and volatility in interest rates. This unanticipated development caught thrifts--with their mandated commitments to long-term fixed-rate mortgages and the newly floating rates paid on deposit accounts--in a bind, about which they could do little. In short, the huge losses by thrifts in the early 1980s that greatly weakened their financial positions were largely beyond their control.

The situation was admittedly made worse by inadequate supervision at the state and federal levels during a period of deregulation that, in retrospect, demanded increased efforts. Relative to total thrift industry assets, the number of Bank Board and FHLBank examination and supervisory personnel declined substantially between 1979 and 1984. The authorized budget for the examination function was allowed to increase only slightly during these years. Furthermore, due to pay constraints, the Bank Board found it increasingly difficult to hire and retain qualified examiners.

And, in retrospect, the Bank Board and the Congress made some strategic errors that exacerbated the present crisis. During the early 1980s, the Bank Board approved regulations that reduced the capital that institutions are required to hold. The minimum capital requirement was reduced, and the list of items that could be included in capital was expanded. Legislation passed in the early 1980s, moreover, provided for broader capital assistance. These actions were based, in part, on the belief that numerous thrift institutions were temporarily troubled and would soon recover.

During 1984, however, evidence mounted indicating that in many instances the "temporary-unprofitability" problem had become an insolvency problem for which forbearance programs were inappropriate. Despite lower interest rates, the number of GAAP-insolvent institutions increased significantly, clearly indicating something fundamental had gone wrong. In hindsight, some of the responses to the problems of the early 1980s--including relaxing accounting and capital standards that permitted excessive growth--exacerbated the problem.

The problems in the thrift industry have been further exacerbated by the timing of key provisions of the Tax Reform Act of 1986 that adversely affect real estate values. Reduced depreciation benefits, limitation on the use of losses on passive investments against other income, and the elimination of the favorable capital gains treatment have all made investment in both commercial and residential property less attractive. For investors in real estate and those that financed such ventures--including many Texas depository institutions already damaged by depressed real estate values following the energy crash--these changes caused financial hardships that could not be anticipated.

Delays in policy implementation also contributed to the current situation. The process through which the Bank Board and the previous Administration requested additional resources to address the industry's problems--and the congressional response--took a great deal of time (nineteen months). The consequent lack of resources limited actions by the Bank Board and, therefore, contributed further to the deterioration of the unhealthy segment of the industry.

Nonetheless, the thrift industry shares some of the blame for the current problems and should help bear the burden of the solution. Many of those most responsible, however, are no longer in the industry. The Bank Board is aggressively seeking redress where wrongful or negligent actions have been a major cause of an institution's problems or downfall. For example, there were 60 staff attorneys working on "director and officer" litigation in January 1989, more than double the number in mid-1987. Results show that the FSLIC is recovering more than $2.50 for every dollar spent on these actions. The recoveries the FSLIC has actually received have increased steadily during the past several years: $72 million in 1986, $76 million in 1987, and $105 million in 1988.

The Bank Board has also attacked fraud by increasing the number of criminal referrals that it has made to the Justice Department in recent years. In 1987, 6,205 cases were referred for prosecution, and another 5,114 cases were referred during 1988. These totals are significantly above the number of referrals in 1985 and 1986--434 and 1,979, respectively. The Bank Board's stepped-up activity has resulted in more criminal prosecutions, and increasing dollar amounts have been recovered through restitution. Over $46 million in restitution was granted to the FSLIC during 1987 and 1988; an additional $23 million was awarded in the first week of 1989.

The Industry Has Borne the Cost Thus Far. To date, healthy thrift institutions have shouldered the burden of financing the costs of resolving troubled thrift institutions. The Financing Corporation (FICO) borrowing authority in CEBA, in particular, is being supported by a special deposit insurance assessment on FSLIC-insured institutions of 1/8 of 1 percent of total deposits and by a capital contribution by the FHLBanks that are owned by thrifts. Attempting to force healthy thrifts to continue to pay

the entire cost of resolution is not feasible and threatens the health of those institutions that have thus far succeeded in a difficult environment.

All these points suggest to me that the President's plan--in which the costs of past thrift failures are broadly shared--is appropriate. Indeed, since a broad spectrum of society has clearly benefited directly or indirectly from the housing policies and the stable financial system of the past 50 years, it should contribute.

THE VIABILITY OF THE THRIFT INDUSTRY

I am confident that the thrift industry will emerge from the current crisis. When it does, what is its future? I would like to point out some characteristics of the industry that help answer this question.

Healthy vs. Unhealthy Thrifts. The salient development in the thrift industry during the last several years has been the increased disparity in the performance and the financial conditi[illegible] among institutions. Industry data have been dominated by the recognition of large losses from write-downs in the value of assets on the balance sheets at insolvent institutions. These losses create the mistaken impression that all thrifts are no longer viable, when, as I have already pointed out, a major part of the industry is quite healthy.

A comparison of the net after-tax earnings of solvent and insolvent institutions reveals the stark dichotomy between the two groups (see Chart 2). Solvent institutions have generated net after-tax profits every year beginning in 1983, including over a 60-basis-point return in 1985 and 1986. Profits in 1987 and 1988 for these institutions were lower, in part, due to reduced profits on loan sales, to larger write-downs, and to changes in accounting treatment of loan fees. In contrast, insolvent institutions have suffered continued and extensive losses. Such losses declined dramatically during 1988, due primarily to a reduction in asset write-downs at these institutions and to actions taken by the FSLIC.

Differences in the performance of solvent and insolvent institutions in part reflect differences in their portfolio strategies (see Chart 3). Solvent institutions, although diversifying to some degree into related activities, remain heavily committed to the residential mortgage market, holding 64 percent of their assets in residential mortgage loans or mortgage-backed securities in September 1988. In contrast, less than 50 percent of the assets of insolvent institutions supported residential properties. In addition, insolvent institutions have dramatically and rapidly increased their commercial mortgage lending in recent years. By September 1988, insolvents had allocated nearly 14 percent of their assets to this category--almost half again more than their healthier counterparts. Similarly, insolvent institutions held an average of 7 percent of assets in foreclosed property (real estate owned); solvent institutions had one percent of their assets in real estate owned.

Most thrifts have remained committed to mortgage assets; very few institutions, solvent or insolvent, have made extensive use of the expanded asset powers that they received in the early 1980s. For instance, in September 1988, only 9 percent of all insolvent institutions had nonresidential commercial loan holdings of greater than 5 percent of their assets. Only 3 percent had consumer loan holdings in excess of 20 percent of assets--the statutory limit for federally chartered institutions on such assets prior to the passage of the Garn-St Germain Depository Institutions Act of 1982. Finally, less than 20 percent had commercial mortgage loan holdings in excess of a fourth of their assets despite the Garn-St Germain limit of 40 percent.

It should be noted, however, that the primary advantage of the thrift charter is that it permits thrifts to specialize in home mortgages while at the same time diversifying into other complementary activities. Without this ability to diversify, thrifts could be seriously exposed to the adverse effects of volatile interest rates.

Mortgage Lending Remains Profitable. Thrifts remain committed to mortgages despite their ability to lend elsewhere because mortgage lending remains profitable. The spread between mortgage yields (including residential and commercial) and thrifts' cost of funds has generally increased since 1982, despite the presence of insolvent institutions that have added to the cost of funds for all institutions. The net margin of mortgage yields over thrifts' cost of funds since the beginning of 1984 has exceeded today's average industry operating expense ratio by an average of 45 basis points (see Chart 4).

Moreover, measures of performance at thrifts improve systematically with increased holdings of traditional mortgage assets: home mortgages (1- to 4-family units) and mortgage-backed securities (see Table 2). In addition to being better capitalized, institutions with relatively large holdings of traditional mortgage assets enjoyed a higher total return on assets in September 1988. Furthermore, these same institutions had fewer delinquent loans and less foreclosed real estate.

In addition to remaining profitable, institutions that have retained their home mortgage orientation have significantly reduced, but not eliminated, their exposure to interest-rate risk in recent years. Since 1984, 90 percent of the institutions holding over 60 percent of their assets in traditional mortgage assets have reduced their interest-rate-risk exposure. And half

Table 2

Selected Measures of Thrift Performance by
Home Mortgage Holdings
(September 1988)

	Home Mortgage Holdings				
	------------Percent of Assets------------				
Item	50 percent or Less	50 to 60	60 to 75	Above 75	All Institutions
Number of Institutions	755	605	1,107	532	2,999
Percent of Institutions	25.2	20.2	36.9	17.7	100.0
Percent of Assets	31.9	24.2	33.3	10.7	100.0
	------------Percent of Assets-----------				
GAAP Net Worth	0.6	2.9	4.7	6.3	3.1
Earnings (Annualized)	-1.9	-0.2	0.3	0.5	-0.5
Real Estate Owned	3.2	1.1	0.7	0.4	1.5
Delinquent Loans	4.6	2.1	1.6	1.0	2.6

Note: Home mortgage holdings include 1- to 4-family mortgages plus mortgage-backed securities.

have cut their exposure by more than 50 percent. These reductions in risk help ensure a more stable income stream for these institutions.

Finally, well-run thrifts have been generating the types of profits that attract new capital. Investors allocate capital to institutions that earn the highest after-tax, risk-adjusted return. The return on equity at GAAP-solvent thrifts generally has been higher than at banks since 1983 (see Chart 5). Thus, thrift institutions have been able to raise more than $10 billion in new equity capital, suggesting that GAAP-solvent FSLIC-insured institutions have been viable competitors in recent years with commercial banks insured by the Federal Deposit Insurance Corporation (FDIC).

The challenge facing mortgage lenders is to maintain an acceptable level of return on equity. Given the intense competition in both the mortgage and deposit markets, this will be accomplished primarily through controlling expenses and appropriate diversification of activities. Since deposit insurance premiums contribute to overall expenses, any substantial increase in assessments may impair the ability of thrifts to attract capital. This is particularly the case when capital requirements are being increased.

Elements of the President's plan will have beneficial effects, mitigating the negative effect of higher assessments and capital requirements. First, the plan will allow us to put this crises behind us. The renewed feeling of confidence that such actions will generate for depositors should continue to reduce the required yields on deposits. Second, insofar as insolvent institutions have paid above-market interest rates, rates offered on deposits should return to more normal levels. Finally, the future premium structure proposed in the President's plan is actually less than some investors may have anticipated. Thus, investors that have been discouraged from investing may revise their calculations.

The Role of Thrifts in Mortgage Markets. The continued commitment of thrift institutions to mortgages makes them key players in the housing finance system in America (see Chart 6). As they have been for many years, thrifts were the largest originator of single and multifamily mortgages in 1988. According to the latest data, thrifts originated over 46 percent of all multifamily mortgages during the first 9 months of 1988. Commercial banks were a distant second at 19 percent. Thrifts also were the largest originator of home mortgages. They were responsible for 43 percent of the originations in the home mortgage market during the first 9 months of 1988. Mortgage companies and commercial banks each originated about 25 percent of the home mortgage market. Of course, many mortgage companies are subsidiaries of thrift institutions. Adding that share of the market to originations by the parent institutions indicates that the thrift industry represents about half the home mortgage origination market.

Thrifts not only play a key role in originating the loans that finance America's housing, they are also one of the primary holders of mortgages. Thrifts hold over a third of the multifamily mortgages outstanding (see Chart 6). Housing finance agencies are far behind with 18 percent of the total, and commercial banks provide only 8 percent of the total. In addition, thrifts directly held 27 percent of all home mortgage loans in September 1988--nearly twice as much as commercial banks. While the largest proportion of home mortgages are now held in "mortgage pools," this category is misleading. These pools are only a conduit for the ultimate investors. And one of the primary owners of mortgage-pool securities is thrift institutions, which held over one-third of the outstanding mortgage-backed securities in September 1988. (In contrast, banks held only 10 percent.) If thrift holdings of mortgage-backed securities were added to their direct mortgage holdings, their share of the total residential mortgage holdings would rise to 38 percent.

To summarize, the thrift industry remains a key player in residential mortgage markets (see Chart 7). Thrift institutions hold nearly 40 percent of all residential mortgages. And in dollar terms, thrifts' total holdings of residential mortgages in September 1988 were $790 billion, nearly double from ten years ago.

REGULATORY AND STRUCTURAL CHANGES TO ENSURE THE PROBLEMS DO NOT RECUR

To meet the challenges of the future, we must address those factors that have created the current problems. Therefore, let me briefly review what caused today's difficulties. Then I will discuss the regulatory and structural changes that have been made to ensure that such problems do not recur.

Causes of Failure. The Office of Policy and Economic Research has undertaken a detailed study of the characteristics of resolved thrifts and costs of resolution (see Chart 8). All 205 institutions that were resolved in 1988 were analyzed; these resolutions are estimated to cost the FSLIC $31 billion. The 50 most costly resolutions in 1988 with an estimated cost of $24 billion were analyzed separately.

Thrifts that required FSLIC action had some distinct characteristics. Fifty-six percent of all 1988 resolutions and 80 percent of the 50 costliest resolutions were state-chartered at the time they became GAAP-insolvent. (On average during the past 5 years, 45 percent of all thrifts were state-chartered.) Many of the most costly resolution cases had relatively heavy holdings of direct investments and brokered deposits. Further, many troubled institutions had grown very rapidly prior to recent regulatory restrictions.

The study also examined the 1988 resolutions for the presence of negligence and fraud. In virtually all cases, the Boards of Directors of resolved institutions were found to not have acted prudently. It is too early to identify more specific incidences of negligence and of fraud for many of the resolved thrifts. However, based on the count to date, loans-to-one borrower violations were present in at least 34 percent of the 205 cases. For the 50 costliest resolutions, such activity was found in 50 percent of the cases. The same proportions hold for the presence of self-dealing. Moreover, in 27 percent of all the 1988 resolutions (and 42 percent of the costliest cases), other forms of fraud were present. Other fraud may be categorized as that perpetrated by outsiders, such as borrowers or by futures and options traders with whom the thrift dealt.

Delay in closing troubled thrifts contributed significantly to the current problem. The combination of the large number of insolvent institutions and the limited number of FSLIC resolutions during the period 1983-1987 led to the situation in 1988 in which many of the thrifts that were insolvent in 1988 had not been viable for quite some time (see Chart 9). In fact, slightly more than half of the 498 GAAP-insolvent institutions at mid-year 1988 first reported having negative capital more than 3 years earlier. The owners and managers of these troubled institutions had incentives to pursue relatively risky strategies during the period.

Recognizing that such incentives existed, the Bank Board has moved aggressively in recent years to harness such risk taking. The Management Consignment Program was established in which the FSLIC takes operating control of those insolvent thrifts that pose the greatest threat of further deterioration. The insolvent thrift's management and directors were replaced to make sure the decision-making process was prudent. In addition, many institutions were brought under supervisory control through consent agreements or other enforcement actions.

Finally, let me emphasize that state-chartered thrifts have dominated the cost of FSLIC actions in recent years. However, the costs of resolving institutions--and the number of resolutions--by different charter types changed dramatically between the early 1980s and the present (see Chart 10). Overall, between 1980 and 1988, a roughly equal number of state and federally chartered institutions were resolved. During the early 1980s, institutions that became troubled while federally chartered were the greater share of the resolutions both in number of institutions and dollar outlays. In recent years, however, institutions that had a state charter when they became GAAP-insolvent were disproportionately represented in the population of FSLIC cases. Also, in terms of cost, state-chartered institutions have dominated FSLIC's resolutions. In 1988, most of the FSLIC's resources were used to resolve institutions located in states that had previously provided broad asset powers to their state-chartered thrifts, including Texas, California, and Florida (see Chart 11). In contrast, most of the FSLIC's expenses during the era of interest-rate-spread problems in the early 1980s had been for institutions located in Illinois and in the Northeast. Our proposed risk-based capital rule will address many of these concerns. If states grant powers that generate increased risk for the thrift, thrifts using those powers will be required to hold more capital.

Regulatory Enhancements. In recognition of the factors that led to the current situation and in anticipation of possible future difficulties, the Bank Board has moved on a variety of fronts to improve and to enhance the quality of regulatory oversight.

To address regulatory policy weaknesses, the Bank Board adopted equity-risk investment, growth, and revised minimum capital regulations. Equity-risk investment regulations were first adopted in 1985 and strengthened in 1987. These rules differentiate between well-capitalized and under-capitalized institutions. The former received extensive investment latitude, the latter being effectively denied any such powers. The Bank Board currently is reviewing the equity-risk regulation. As part of this process, we recently submitted to the Congress an extensive report on the use of such powers by thrifts.

Rapid growth, unsupported by capital, was initially limited in 1985 and prohibited by 1988. Similarly, the use of brokered deposits by weakly capitalized thrifts, often the fuel for this rapid growth, was restricted in early 1985 and was further limited by growth restrictions in September 1988.

Moreover, the Bank Board has revised its minimum capital regulation to better bring it in line with the risk characteristics of thrift institutions. Changes in 1985 eliminated long phase-in procedures that had allowed capital requirements to lag far behind the capital needs of rapidly growing thrifts. In January 1987, the Bank Board amended its regulation to require all growth to be supported by six percent capital. In addition, adjustments were made in institutions' capital requirements for high-risk assets and for interest-rate risk.

In December 1988, the Bank Board proposed extensive revisions to the minimum capital (risk-based capital) requirements so that they would more fully reflect the risks that an institution poses to the FSLIC. These proposed rules address both credit-risk and interest-rate risk. Furthermore, they capture most off-balance-sheet risks. The proposed rule closely parallels commercial banks' requirements in the area of credit risk, but goes further to address interest-rate risk, a risk we believe is too important to ignore. The bank rule does not adjust for interest-rate risk.

In addition, in December 1988 the Bank Board asked for public comment on a rule that would allow "early intervention" at an institution whose capital on a GAAP basis falls below 1.5 percent of total assets. This proposal will be an important new tool in the Bank Board's arsenal to ensure strong capital discipline and will limit losses to the deposit insurance fund.

To head off potential future problems, we have issued a number of regulatory bulletins. For example, one establishes guidelines for the use of mortgage derivative products and mortgage swaps and limits the use of such instruments by insolvent, weakly capitalized, and otherwise troubled institutions. Another addresses thrift investment in high-yield ("junk") bonds and provides detailed guidance on appropriate underwriting standards. And yet another establishes guidelines for thrifts to use in monitoring and in controlling interest-rate risk. (A more detailed discussion of this and other recent regulatory enhancements is attached as Appendix B.)

Supervisory Response. As the industry was deregulated, some thrift managers undertook new activities and lines of business before they acquired the skills necessary to run such operations safely. Weak or fraudulent management, inadequate capital, and insufficient state regulatory oversight combined to create severe problems. The Bank Board's supervisory and examination staff was also not well prepared for the new activities. The Bank Board transferred the examination staff to the District Banks in July 1985 to improve both the quantity and quality of the staff. Both goals have been accomplished. In terms of quantity, the examination and supervision staff has nearly doubled since 1985. The staff has expanded from 1,063 in June 1985 to 2,068 in June 1988.

The Bank Board also has improved the training and education of examiners. To ensure that thorough, consistent, and appropriately targeted examinations are made, the Bank Board has developed specific procedures that examiners perform when evaluating a thrift institution or its subsidiaries. These procedures emphasize safety and soundness, using a "top-down" approach of evaluating management, policies, and procedures.

We have also increased the frequency of exams. Well-run institutions are examined at least every 18 months. Those with problems are examined more frequently, with a "full scope" exam at least annually. Our examinations place special emphasis on the ability of management and the prudence of activities.

The Office of Enforcement also intensified its efforts. In 1988, 47 individuals were removed from their positions at thrifts and barred from further participation in the savings and loan industry. Even more individuals were released from their thrift management positions when the FSLIC appointed receivers or conservators for their failed institutions. Other actions in 1988 included 110 supervisory agreements, 102 consent merger resolutions and agreements, 65 investigations (both formal and informal), and 26 cease and desist orders. Similarly in 1987, 44 individuals were removed from their positions and barred from further participation in the savings and loan industry, 106 supervisory agreements were entered into, 102 consent merger resolutions and agreements were finalized, 68 investigations (both formal and informal) were conducted and 25 cease and desist order were issued.

Another area of increased oversight has been in the area of institutions undergoing changes of control. In the early 1980s, these changes too frequently led to major shifts in management that resulted in poor decision making. The Bank Board has not only strengthened the change-in-control regulations, but it has also improved its sharing of information with federal commercial bank regulators regarding the background of potential investors. Many state authorities have also strengthened their change-in-control regulations.

The Need for a Separate Thrift Regulator. I believe the actions just outlined significantly improved the regulatory environment. Let me now take a moment to address the desirable distinction between regulatory efforts for different types of depository institutions.

It is a common misconception that banks and thrifts have become very similar. As regards the asset composition at banks and thrifts, however, in September 1988 GAAP-solvent thrifts held almost 75 percent of their assets as mortgages, mortgage-backed securities, and other mortgage assets (see Chart 12). In contrast, FDIC-insured commercial banks held less than 25 percent of their portfolios in mortgage assets. In addition, banks held 30 percent of their assets as liquid assets, roughly three times thrift holdings. This difference is not surprising given the large amount of demand deposits at commercial banks. Finally, consumer loans and commercial and industrial (C&I) loans are more than 25 percent of bank assets, but less than 7 percent of thrift assets.

Thrifts' long-standing commitment to housing finance--which I believe should be retained and encouraged--means that they are exposed to risks that are quite different from those generally associated with commercial lending. Unlike commercial lending, mortgage finance inherently involves managing interest-rate risk. This leads to different investment strategies and different regulatory and supervisory problems.

Legislation enacted at both the state and federal level in the early 1980s broadened the range of assets thrift institutions could acquire. The intent was to enable thrifts to diversify their portfolios into assets with shorter effective maturities that would complement their mortgage holdings, thus balancing part of the interest-rate risks they faced. These powers have, in fact, proved to be valuable to the industry, as most institutions have used them prudently and effectively. While a 100-basis-point increase in interest rates would have reduced the return on assets by 40 basis points in 1984, the same increase in rates would reduce earnings only 17 basis points in 1988.

Recently, the financial markets have developed a variety of new mortgage instruments as well as other securities and types of transactions that enable mortgage lenders to further reduce their exposure to interest-rate risk. The unique and complex job the thrift regulator will be facing in future years is to evaluate the risks associated with such instruments and to make sure thrifts holding these assets use them in a safe and sound manner.

Because the asset portfolios and corresponding risks at thrifts and banks remain quite different, a distinct regulatory apparatus is appropriate. This distinction between thrifts and banks, however, should not blur the fact that in terms of market strategies small banks often behave more like thrifts than like their large money-center counterparts. For example, small commercial banks and thrifts both have a community orientation. Like thrifts, small commercial banks hold virtually no foreign loans or foreign deposits. While thrifts focus on the mortgage side of the business, small banks focus on local commerce and mortgages. Thus, while the risk characteristics of banks and thrifts necessitate separate regulatory structures, the community orientation of small commercial banks may justify their participation in programs such as access to Federal Home Loan Bank advances and other services provided by the District Home Loan Banks, that at present are limited to thrifts. I would hope that, during its current deliberations, Congress would consider the possibility of bank access for borrowing from--and possibly even membership in--the Federal Home Loan Banks.

CLOSING REMARKS

In an address I made before the National Press Club shortly after I became Chairman of the Bank Board, I identified a 3-prong agenda: (1) to reaffirm our commitment to the safety of deposits, (2) to rebuild the agency, and (3) to resolve problems associated with troubled institutions. I believe I have followed this agenda. No depositor has lost a penny in an insured account, and depositors remain confident in the safety of their savings. The Bank Board and the Bank System have been rebuilt and strengthened. We have attracted highly talented people to staff the agency and the Bank System. Finally, over 225 troubled institutions have been resolved since I became Chairman. While more troubled institutions remain, we have taken significant

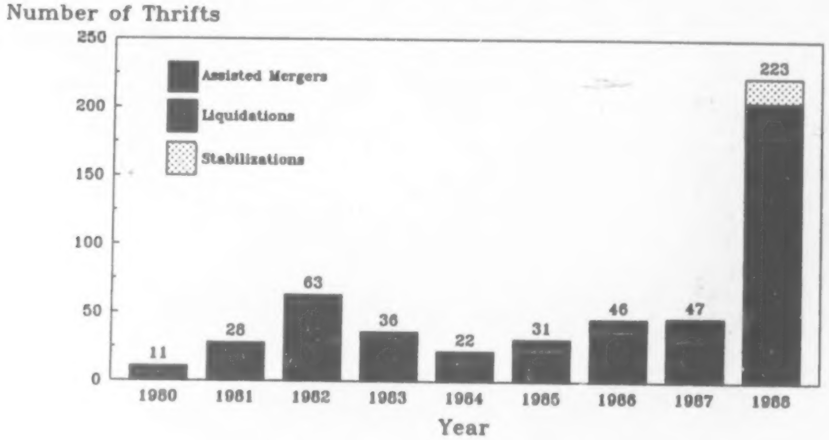
steps to make sure that the thrift industry of the future is both safe and sound and capable of fulfilling its historic role as the key provider of housing finance.

Much of what remains to be done--and there is much to do--can only be accomplished if the Congress is willing to move forward. You need to provide the resources to permit us to deal with the remaining troubled thrifts and to continue to implement regulatory and supervisory changes that ensure the continued viability of the healthy segment of the industry.

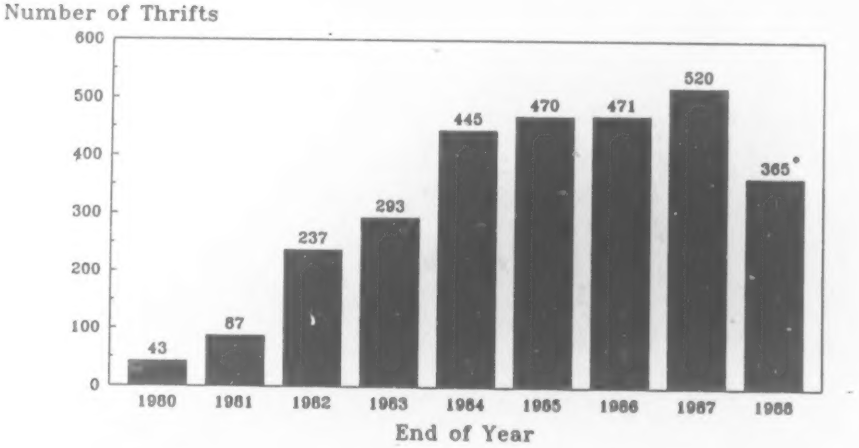
Exhibit 1

FSLIC Resolution Actions and GAAP–Insolvent Thrifts

FSLIC Resolution Actions



GAAP–Insolvent Thrifts



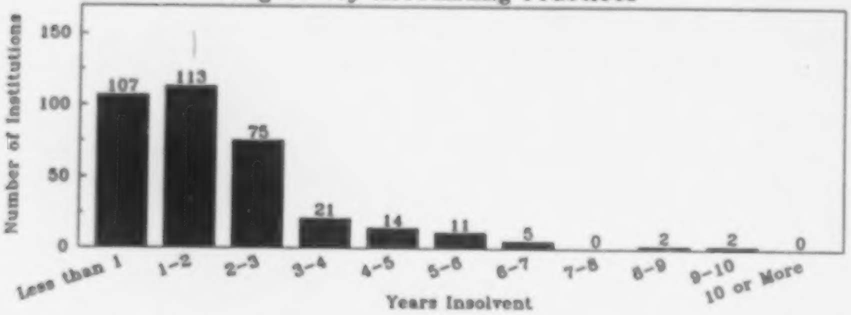
* Preliminary.

Prepared by the Office of Policy and Economic Research.

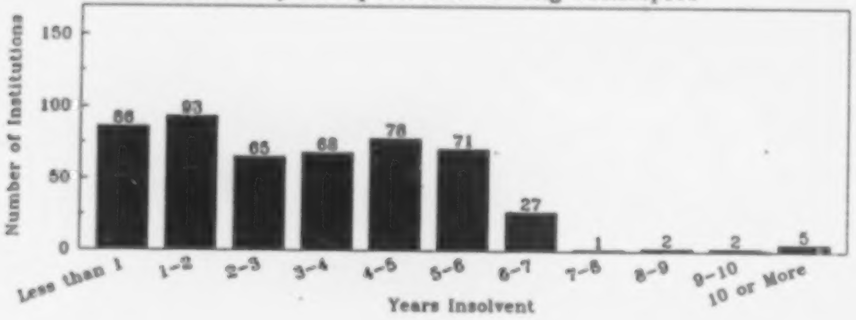
Exhibit 2

FSLIC–Insured Insolvent Institutions: Length of Insolvency

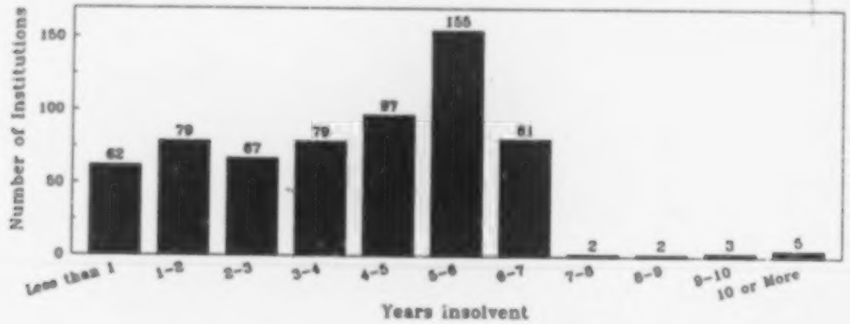
Regulatory Accounting Practices



Generally Accepted Accounting Principles



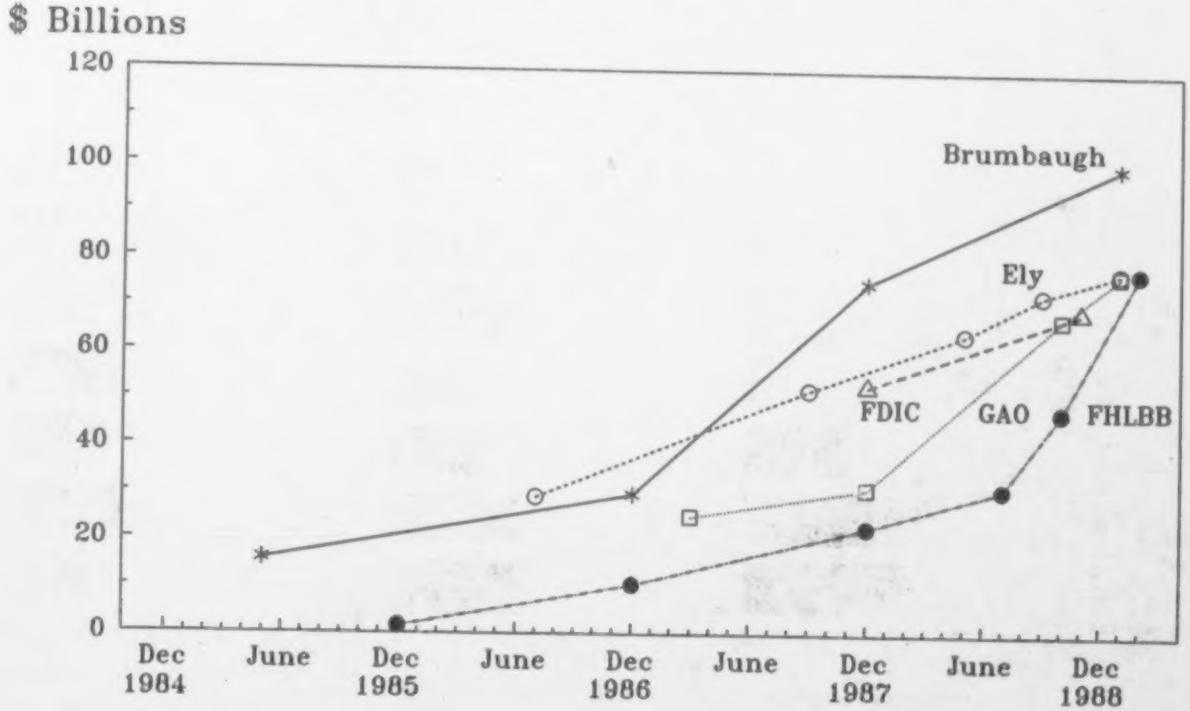
Tangible Capital



Prepared by the Office of Policy and Economic Research, using June 1988 data.

Chart 1

Selected Estimates of Thrift Insolvency Costs



Notes to Chart 1

All estimates are on a present-value basis, except as noted, meaning that this is the amount the FSLIC would have to pay to an acquirer to immediately assume its liabilities. When the estimate was stated as a range, the midpoint of the range was charted. The estimates prior to 1988 do not include costs associated with FSLIC's provisions for future losses on assistance agreements or FSLIC's notes payable.

Dan Brumbaugh is a consultant based in San Francisco, California. Brumbaugh arrives at his estimates by multiplying the assets of a predefined group of institutions by the FSLIC's average historical cost to resolve institutions during a recent period. Brumbaugh's December 1987 and January 1989 estimates include the costs of resolving solvent but troubled institutions. Brumbaugh's May 1985 and December 1986 estimates include only the costs of resolving insolvent institutions.

Bert Ely is a consultant based in Alexandria, Virginia. Ely's May 1988, September 1988, and January 1989 estimates are the simple average of the marked-down value of assets and the capitalized value of gross interest income. Estimates prior to May 1988 are based on the capitalized gross interest income stream. Ely's September 1987 estimate was stated as "at least 52 billion" and was based on March 1987 balance sheet data. Ely's September 1988 estimate was a range, $70-$75 billion, twenty to twenty-five percent of which was on the books of the FSLIC. Ely's January 1989 estimate was a range, $75-$80 billion, half of which was on the FSLIC's books. Ely's last two estimates were based on June 1988 financial data.

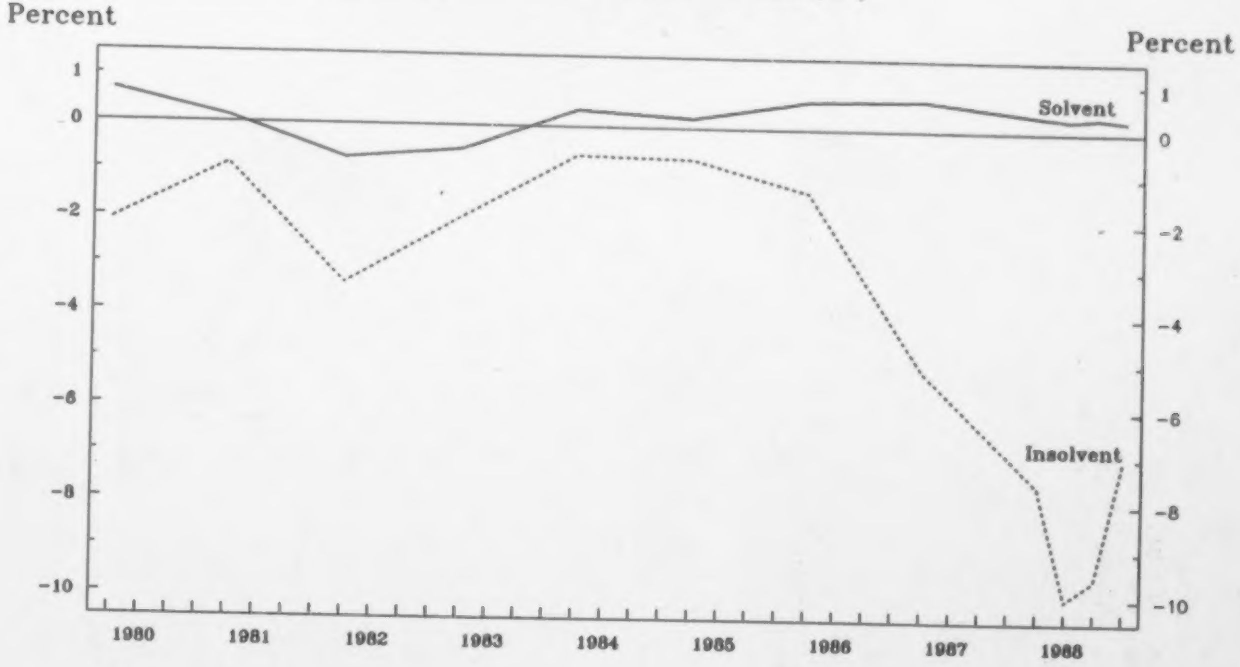
The General Accounting Office's January 1989 estimate was "at least $77 billion" of which $37 billion was for institutions that had already been resolved and $40 billion was for institutions that had not yet been resolved. The GAO's May 1988 estimate was a range, $26-$36 billion, and was based on the December 1987 financial audit. The GAO's estimates based on 1988 data were intended to include the costs of 1988 FSLIC actions to date that had been assumed by the FSLIC. The GAO's October 1988 estimate for the costs of resolving institutions that were insolvent at the end of September was a range, $45-$50 billion, to which $19.9 billion of FSLIC's provisions for losses and notes payable needs to be added. Thus, the October estimate ranged from $64.9-$69.9 billion. The GAO's March 1987 estimate is taken from its report to the Congress in which the GAO stated that given its "knowledge of the condition of the industry, we do not believe that $25 billion overstates the extent of the problem facing FSLIC."

The Federal Deposit Insurance Corporation's estimates include the costs of handling resolved institutions plus institutions that were unprofitable and insolvent. Institutions are insolvent for these estimates if the sum of tangible capital, loan loss reserves, and general valuation allowances is less than zero. The FDIC reduces the asset values at insolvent and unprofitable institutions by comparing the book value of these assets with corresponding book values of a related group of peer institutions. The liabilities of the insolvent and unprofitable institutions are then subtracted from the adjusted asset values to obtain a cost estimate for resolving these institutions. The FDIC's December 1987 estimate of $52.8 billion was based on 489 insolvent and unprofitable institutions holding assets of $209 billion. The FDIC's November 1988 estimate of $68.9 billion was based on 134 resolved institutions through October 20, 1988 and 396 institutions holding $167 billion in assets, yet to be resolved. The FDIC's November estimate was split between FLSICs' books, $24.8 billion, and the unresolved institutions.

The Bank Board's December 1985 estimate of $1.6 billion was a contingent liability for troubled institutions that the Bank Board believed would likely require financial assistance in the near term. This estimate was based on FSLIC's historical loss experience and an evaluation of the past and present financial condition of such institutions. This methodology focused on near term losses, and was not a projection of the cost of resolving all future problems in the savings and loan industry. The Bank Board's December 1986 estimate of $10.5 billion included only those institutions on the FSLIC case list as of December 31, 1986. This liability represented the present value of the estimated total cost to provide the most probable form of assistance in each case less any costs already recognized because of some currently provided FSLIC assistance. The Bank Board's December 1987 estimate of $22.7 billion or more included a contingent liability of $17.4 billion for future assistance to troubled (unresolved) institutions that was probable and estimable and the costs (at least $5.3 billion) to resolve the problems of the additional 300 GAAP-insolvent institutions. The contingent liability included bid prices received by the FSLIC and the estimable and probable resolution costs of the remaining thrifts in the FSLIC caseload; plus an additional allowance for institutions located in the Southwest that were not part of the FSLIC caseload as of December 31, 1987. The Bank Board's mid-year estimate of $30.9 billion revised the December 31, 1987 estimate upwards by $8.2 billion for institutions in the Southwest based on an analysis of actual resolution costs on Southwest cases compared to year-end estimates. The Bank Board's October 1988 estimate was a range, $45-$50 billion, based on all unresolved institutions in FSLIC's caseload a of October 1, 1988 plus all other thrifts that were GAAP insolvent in June 1988 but not in FSLIC's caseload. Using its experience from resolving thrifts during the first three quarter of the year, the Bank Board estimated a range of costs for the resolution of future FSLIC cases, $24.9 to $29.9 billion. To this must be added the estimated $20 billion in FSLIC notes and guarantees under assistance agreements of previously resolved cases. The Bank Board's February 1989 estimate is a range, $75-80 billion.

Chart 2

Net After-Tax Earnings of Thrifts
By GAAP Solvency Status
(Earnings as a Percent of Assets)

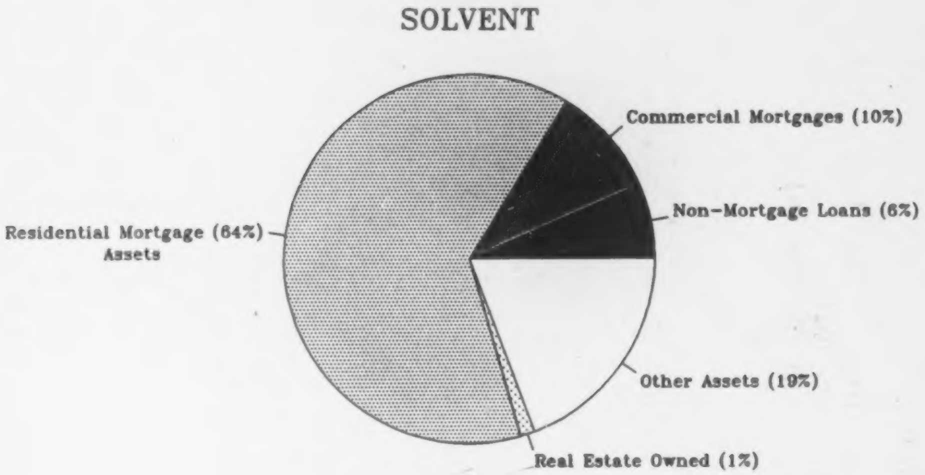


Prepared by the Office of Policy and Economic Research.

Chart 3

Portfolio Composition of Thrifts By GAAP Solvency Status

September 1988



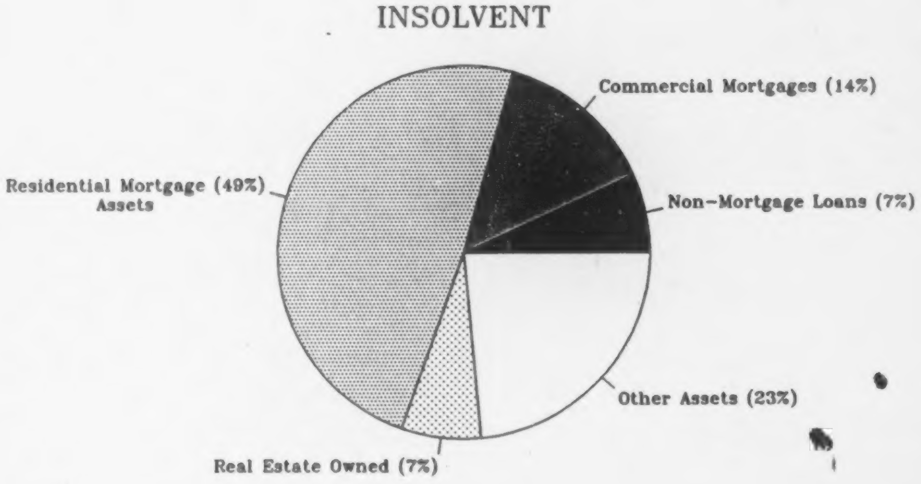


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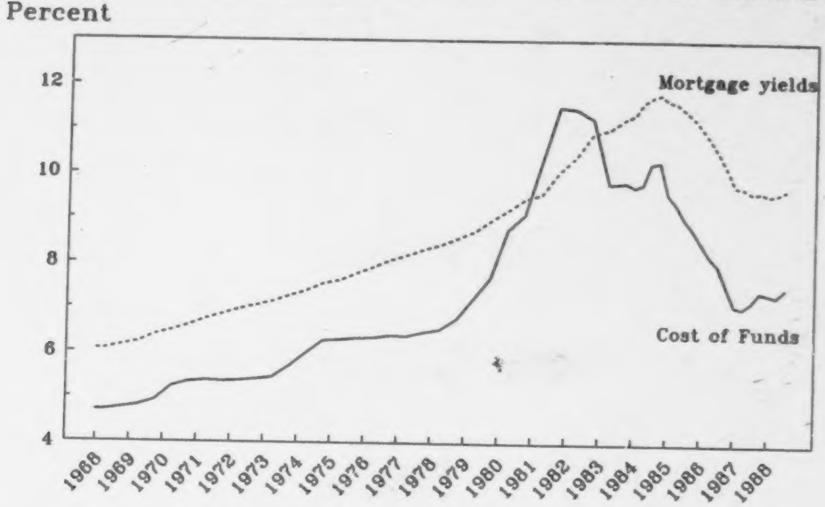
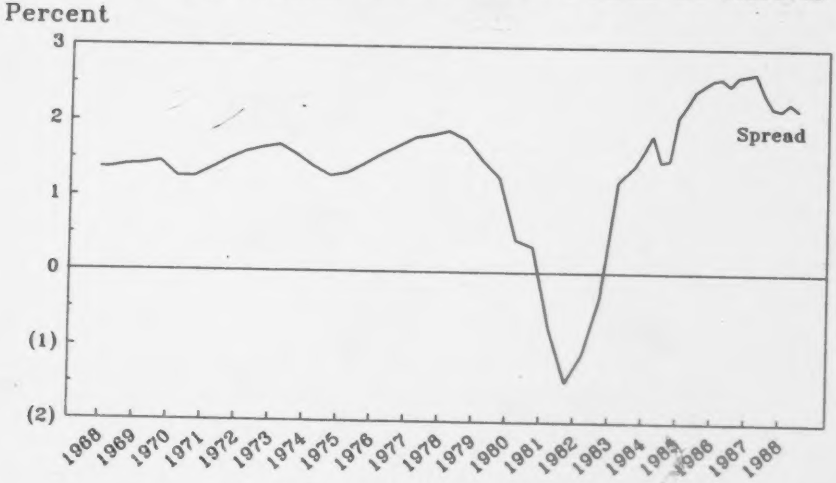
Chart 4

Mortgage Yields and Cost of Funds at Thrifts



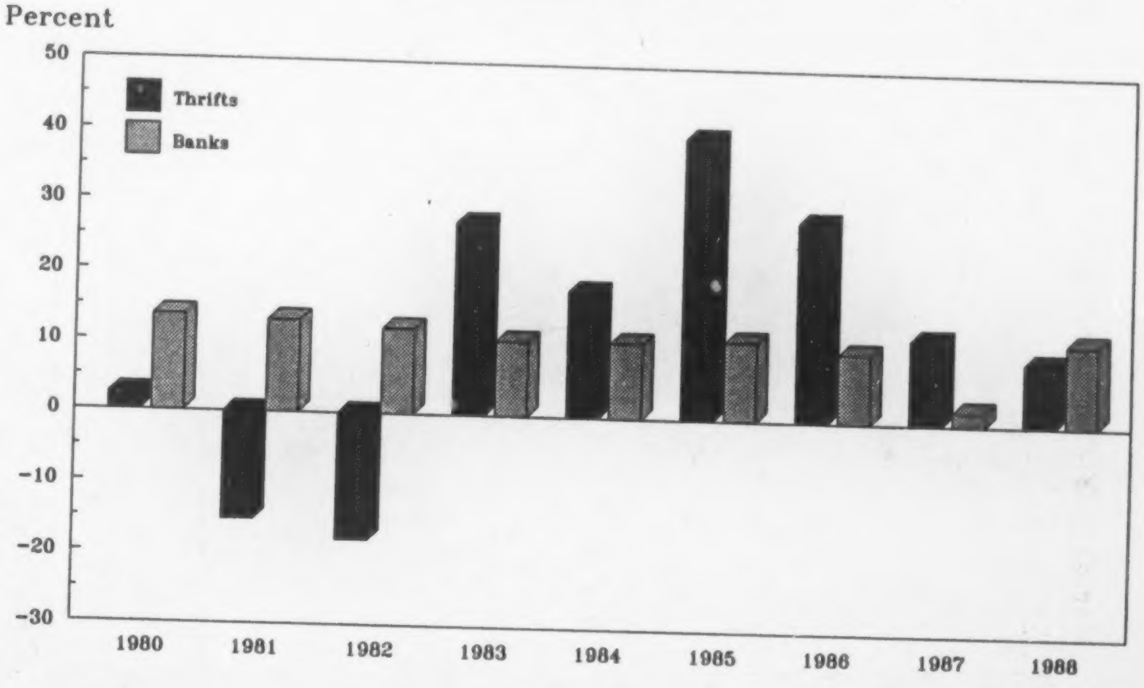
Mortgage Yields Less Cost of Funds at Thrifts



Prepared by the Office of Policy and Economic Research.

Chart 5

Return on Equity for GAAP-Solvent Thrifts And Commercial Banks

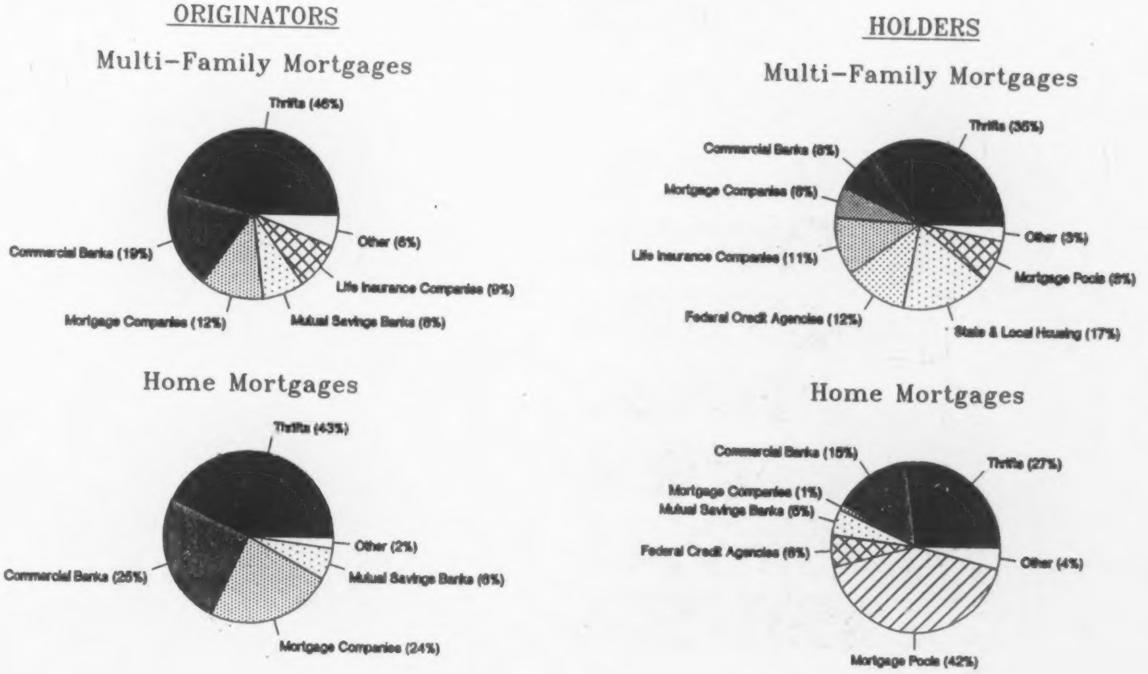


NOTE: 1988 data for first three quarters at annual rate. Income and equity measured on a book-value basis.

Prepared by the Office of Policy and Economic Research.

Chart 6

Residential Mortgage Activity
September 1988


ORIGINATORS

HOLDERS

Multi-Family Mortgages

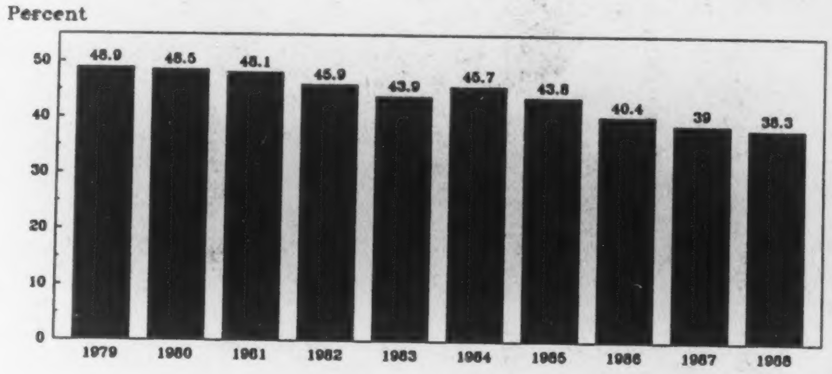
Home Mortgages

Prepared by the Office of Policy and Economic Research.

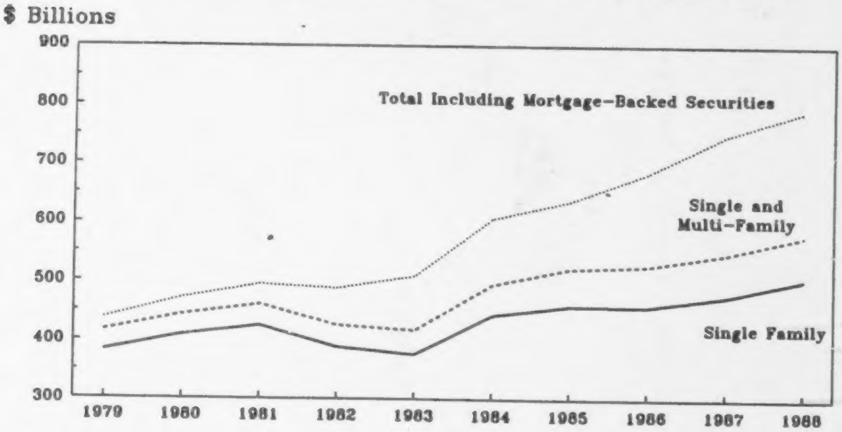
Chart 7

The Role of Thrift Institutions in Residential Mortgage Markets

Thrift Holdings of Residential Mortgages as a Proportion of Total Outstanding Residential Mortgages



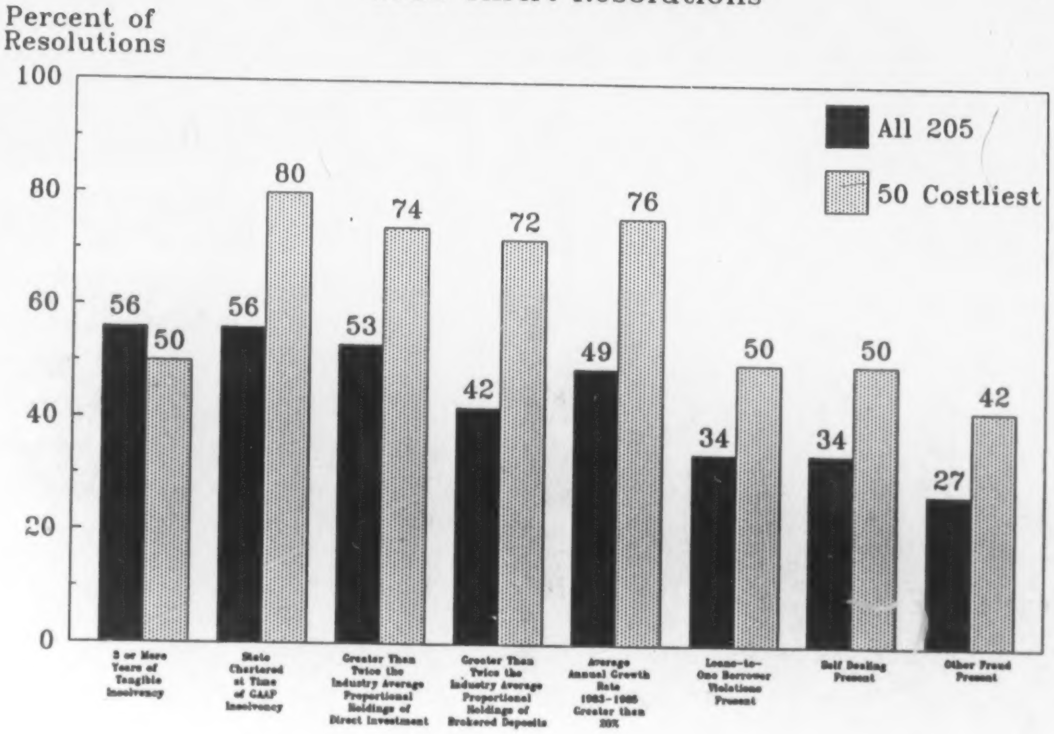
Residential Mortgages Held by Thrifts



Prepared by the Office of Policy and Economic Research.

Chart 8

Selected Characteristics of 1988 Thrift Resolutions

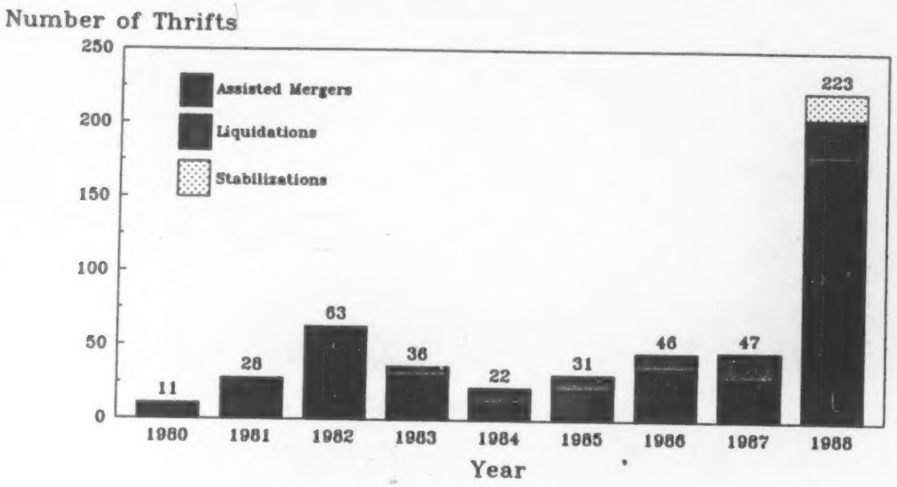


Prepared by the Office of Policy and Economic Research.

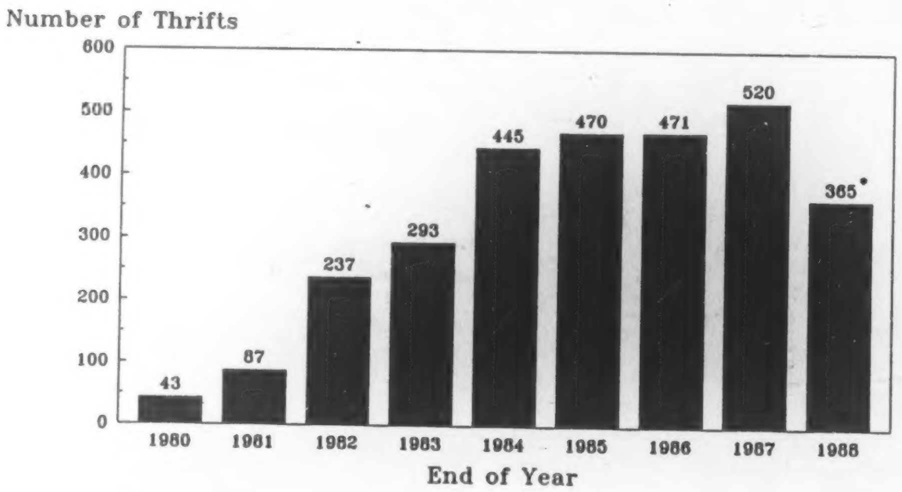
Chart 9

FSLIC Resolution Actions and GAAP–Insolvent Thrifts

FSLIC Resolution Actions



GAAP–Insolvent Thrifts



* Preliminary.

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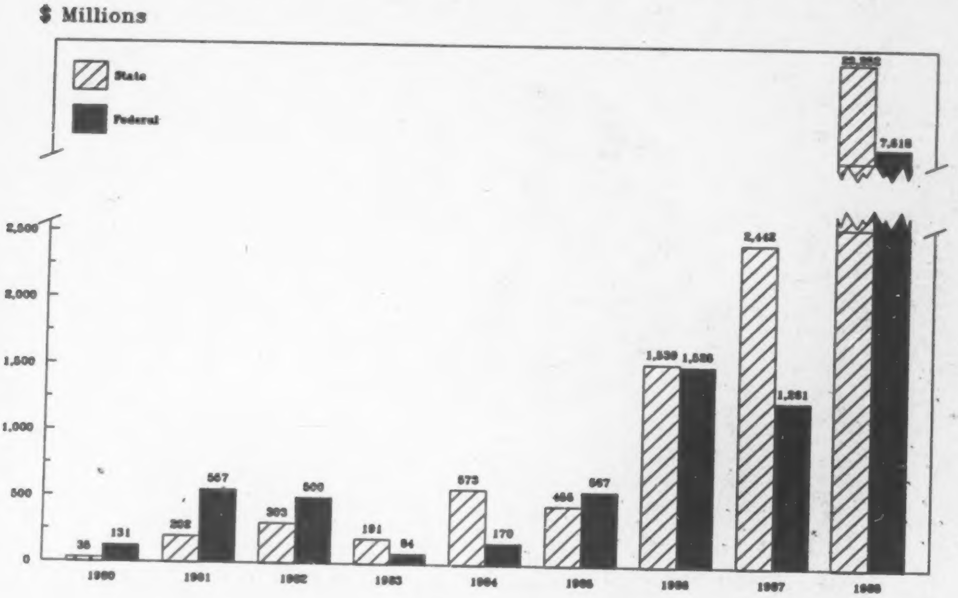
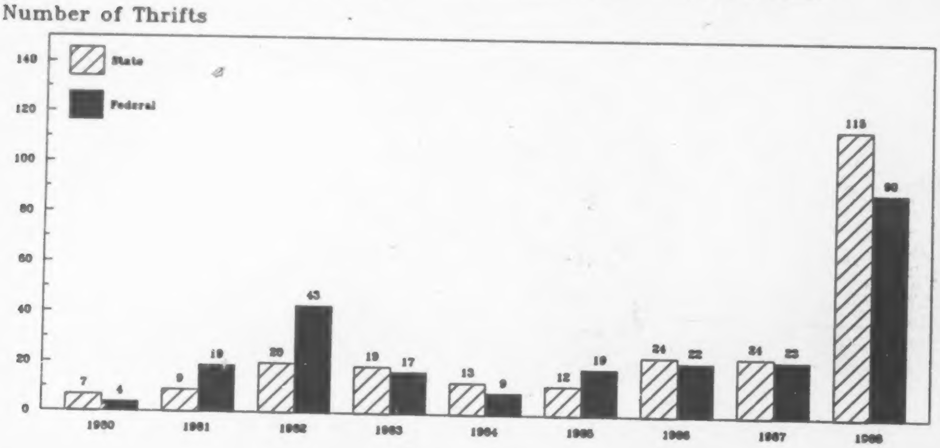
Chart 10

Resolution Costs of State and Federally Chartered Thrifts



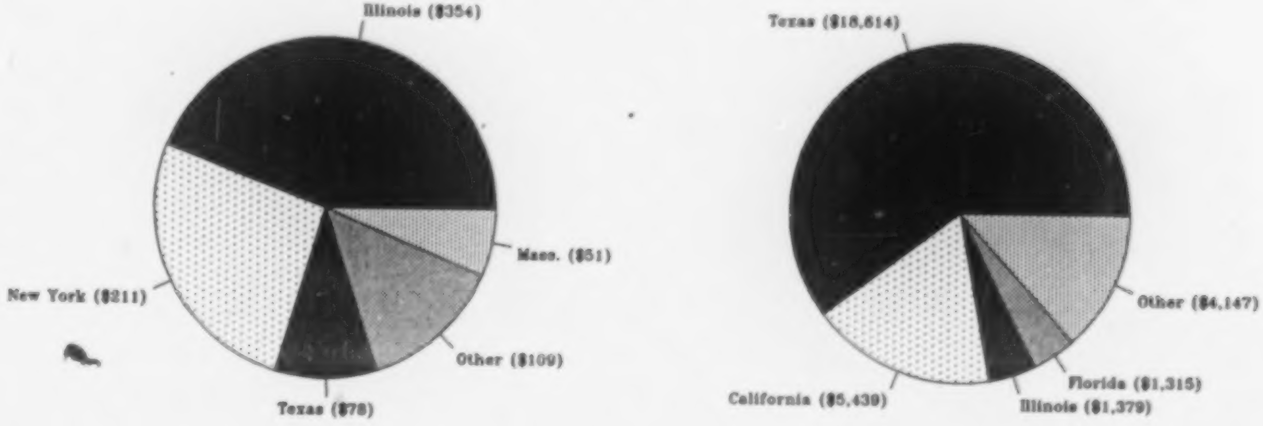
State and Federally Chartered Thrift Resolutions



Prepared by the Office of Policy and Economic Research.

Chart 11

States with the Highest FSLIC Resolution Costs
1982 and 1988
($ Millions)



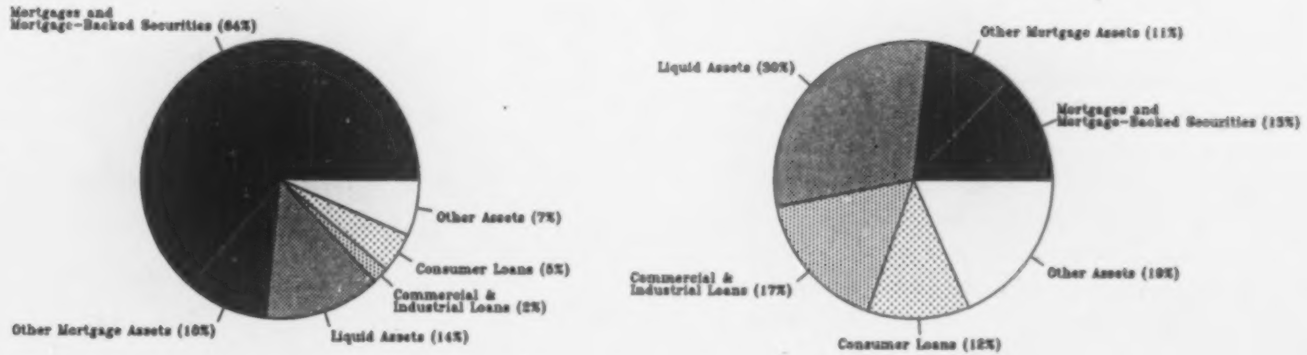
1982 Total:
$803 Million

1988 Total:
$30,894 Million

Prepared by the Office of Policy and Economic Research.

Chart 12

Asset Composition of GAAP–Solvent Thrifts and Banks
September 1988



GAAP–Solvent Thrifts

Commercial Banks

Prepared by the Office of Policy and Economic Research.

APPENDIX A

ALTERNATIVE FEDERAL DEPOSIT INSURANCE REGIMES

by

James R. Barth, John J. Feid, Gabriel Riedel,
and M. Hampton Tunis

The Office of Policy and Economic Research
Federal Home Loan Bank Board

January 1989

James R. Barth is director, John J. Feid is financial economist, Gabriel Riedel is research assistant, and M. Hampton Tunis is financial analyst, respectively, in the Office of Policy and Economic Research, Federal Home Loan Bank Board. The authors wish to thank M. Bradley, R. Cole, C. Edwards, E. Hirschhorn, B. Miller, and R. Roeske for comments and suggestions on the original draft of this paper and for sharing information from their ongoing research. We also wish to thank C. Thomas for typing sections of this manuscript. As always, any remaining errors of commission or omission are the responsibility of the authors. The views expressed are those of the authors and not necessarily those of the Federal Home Loan Bank Board or its staff. An earlier version of this paper was presented to the Committee on Budget, U.S. Senate, October 5, 1988.

ABSTRACT

This paper traces the evolution of the federal deposit insurance system. We discuss the initial and subsequent changes in the legislated insurance assessment and the level of basic insurance coverage for the FSLIC and the FDIC. Data are provided on the reserves and costs incurred for both deposit insurance funds. Much of the discussion centers on the reserves at each fund in comparison with the actual cost experience. In retrospect, it is found that the insurance assessment did not increase rapidly enough when the reserves relative to the insured deposits fell for the FSLIC. More generally, primary assessments for the FSLIC have not been adjusted to reflect the actuarial data on insurance fund costs. Only during the recent period of unprecedented FSLIC losses has the primary assessment been increased; and then only as an extension of the Federal Home Loan Bank Board's emergency assessment powers. We also calculate the effect that higher primary assessment premiums might have had on the FSLIC insurance reserve fund.

I. History of the Federal Deposit Insurance Funds

On June 27, 1934, the Federal Savings and Loan Insurance Corporation (FSLIC) was created by the National Housing Act of 1934 (NHA), PL-73-479, and placed under the aegis of the Federal Home Loan Bank Board (Bank Board).

Section 404(a) of the NHA mandated that a deposit insurance reserve be established and that this reserve should, within 20 years, be equal to 5 percent of all insured accounts and creditor obligations of all insured institutions. To establish this reserve, the FSLIC was empowered to levy an annual insurance premium of 1/4 of one percent (25 basis points) on total deposits and creditor obligations. Section 404(b) provided the option to assess an additional 1/4 of one percent per annum in the event the insurance fund administrators found that the funds generated by the primary reserve premium were insufficient to cover expenses in any given year. Initially, basic insurance coverage was set at $5,000 per individual depositor.

The Federal Deposit Insurance Corporation was created when Section 12B of the Federal Reserve Act was amended by Section 8 of the Banking Act of June 16, 1933, PL-73-66. Section 8(y) mandated the creation of a Temporary Deposit Insurance Fund. The law provided for an annual insurance premium of 1/2 of one percent (50 basis points) of insured deposits. The first half of the assessment was due upon admission to the fund and the remainder was subject to call at the discretion of the administrators of the fund. In the event costs were incurred that exceeded the primary assessment, an additional assessment was available

that was not to exceed the amount paid into the fund for that year (for a possible maximum special assessment of 1/2 of 1 percent of total deposits). Since the FDIC chose not to call the remainder of the primary assessment, the effective insurance premium was equal to 1/4 of one percent of total insured deposits. The initial basic insurance coverage was set at $2,500 per individual depositor.

The Banking Act of 1935, PL-74-305, revised the insurance premium and its assessment base effective August 23, 1935 following FDIC Chairman Leo Crowley's earlier testimony on February 22 before the House Committee on Banking and Currency. The historical analysis of the cost of commercial bank failures supplied by Crowley appears to have been instrumental in setting insurance premiums not only for the FDIC, but for the FSLIC as well. Crowley produced historical data on the losses to depositors resulting from commercial bank failures for the period following the development of the national banking system on July 1, 1864 through June 30, 1934. These data showed that the average loss per total deposit dollar was approximately 1/3 of one percent (32 basis points) for this 70-year period. If, however, the periods of episodic crisis were removed from the data set (the three crisis periods of 1873-78, 1892-97, and 1931-34), the average loss per dollar of total deposits declined to 1/8 of one percent (12.5 basis points) [Congress, 1935B, p. 9]. Crowley's data also showed that if insurance liabilities were limited to deposits under $5,000, an average annual premium of 24 basis points would have covered all insurance liabilities for the entire period. (Congress later limited deposit insurance coverage to $5,000 per depositor. The 24-basis-point average loss per dollar on deposits of $5,000 or less at commercial banks coincided roughly with the effective premium already in place for the FDIC and the actual premium for the FSLIC).

Crowley argued that under the then-current circumstances, banks would be hard pressed to meet even the premium needed to provide full protection for the non-crisis years. He further argued that strict enforcement of bank regulations would lessen the probability of bank failures. In addition, he argued that the legislation should include a provision allowing the FDIC to borrow limited funds from the Treasury in the event costs arose that overwhelmed the deposit insurance reserve fund. The FDIC could reduce 's possible deficit by raising the premium on deposit insurance when banks would be better able to afford it. He suggested, therefore, that the premium be set at the rate of 1/12 of one percent (8.3 basis points) for total deposits [Congress, 1935B, pp.# 48-49]. Congress subsequently accepted his proposal and it was included in the Banking Act of 1935 [Congress, 1935D, p. 6]. This law also eliminated the special assessment abilities of the FDIC but provided for an emergency line of credit with the Treasury of $975 million.

On May 28, 1935, Section 404 of the NHA was amended at the request of the Bank Board, as suggested to the Committee on Banking and Currency in the House of Representatives on February 12, 1935, by Bank Board General Counsel Horace Russell. As part of the revisions of the NHA, Russell suggested that the FSLIC insurance premium on deposits be lowered to 1/8 of one percent of total deposits. Although he offered no specific justification for this revision, no one on the Committee

apparently questioned his suggestion and the amendment was subsequently ratified [Congress, 1935A, p. 57 and Congress, 1935C, p. 42]. The law also reduced the special assessment abilities of the FSLIC to 1/8 of 1 percent of total deposits.

In the Third Annual Report of the Federal Home Loan Bank Board it was reported that the decrease in the premium was requested on behalf of savings and loan associations. In particular, the report stated that many savings and loans operated on a narrow profit margin and, therefore, these organizations questioned their ability to pay the original insurance premium. Consequently, they did not apply for federal deposit insurance from the FSLIC. The lower premium, it was felt, would increase the number of applicants [FHLBB, 1936, p. 76].

Russell's premium proposal was the same as the premium needed to insure complete coverage of commercial bank deposit losses for the non-crisis periods documented in Crowley's FDIC report. The lack of congressional debate about the appropriateness of the premium suggests that the content of Crowley's report was known before it was officially presented to the Committee ten days later. Lack of debate about the proposed uniform reduction in premiums undoubtedly reflects the congressional desire to levy premiums for both organizations in a similar fashion. Both the FSLIC and the FDIC had access to limited funds in the event of an emergency, albeit in different forms and different amounts.

From the outset then, the FDIC insurance fund was not designed to cover the deposit losses resulting from known periods of economic crisis. After the Great Depression, neither the FDIC nor the FSLIC attempted to increase insurance premiums to bring them closer to the premiums needed to cover the historical loss data presented by Crowley or the then-more-recent losses resulting from the severe economic downturn.

In 1950, Congress decided that both the FSLIC and the FDIC had more than sufficient insurance reserves and that the then-present rate of accumulation was unnecessary in the economic environment following WWII. Thus, in 1950, the FSLIC had its annual premium cut to 1/12 of one percent of total deposits, while the FDIC had its premium reduced, in effect, by being required to rebate "excess" net assessment income.

The reduction in the insurance premium charged by the FSLIC was opposed by then-Chairman William K. Divers in testimony before the House Committee on Currency and Banking on January 18, 1950 [Congress, 1950A, pp. 8-17]. Despite this opposition, Public Law 81-576, enacted on June 27, 1950, reduced the premium charged insured institutions. The reduction in the insurance premium was retroactive to June 30, 1949 (so that it covered fiscal year 1950). At that time, there was also a proposal to eliminate the special assessment abilities of the FSLIC in lieu of a line of credit with the Treasury similar to that of the FDIC. However, the law enacted allowed the FSLIC to retain its special assessment powers, but included a provision establishing an emergency line of credit with the Treasury up to $750 million. [Congress, 1950C].

The FDIC's reduction was in the form of a premium rebate system whereby the FDIC was to refund 60 percent of net annual (as of December 31, 1950) assessment income. This legislation, the Federal Deposit

Insurance Act, PL-81-797, made it clear that Congress felt that the FDIC had more than sufficient reserves to meet any contingency and that the continued growth of the FDIC's insurance fund at the former rate was unnecessary [Congress, 1950B and Congress, 1950D].

Between 1960 and 1980, the FDIC's share of net annual assessment income was reduced again. However. a major portion of this reduction reflected a change in the computation used to determine the assessment base of the premium. In 1980, for the first time since the 1935 legislation, the FDIC was granted an increase in the effective premium it assessed insured institutions. This was done by lowering the normal rebate percentage to 60 percent of net annual assessment income and adjusting the rebate as needed so as to maintain a ratio of deposit insurance reserve fund to estimated insured deposits between 1.1 and 1.4 percent.

By contrast, deposit growth in the thrift industry accelerated in the middle 1950s and, by 1959, the FSLIC's ratio of insurance reserve fund to insured deposits had fallen to a historic low of 0.63 percent. As a result, on September 8, 1961, Public Law 87-210 authorized the FSLIC to build a prepayment of the primary assessment reserve, a secondary reserve, by levying a 2 percent annual assessment on anticipated net increases in total deposits. When the ratio of total insurance fund reserves to total deposits reached 2.0 percent the depository institution's secondary reserve contribution would be credited toward its primary reserve assessment with the caveat that the reserve/deposit ratio for total reserves (primary reserves plus secondary reserves) should be maintained between 1.6 and 2.0 percent (the historic average reserve/deposit ratio for FSLIC was 1.2 percent).

On August 16, 1973, Congress passed PL-93-100, suspending payments to the secondary reserve. The mandate included a provision for repayment of the secondary reserve to depository institutions within ten years, with the caveat that the FSLIC ratio of insurance fund total reserve to total deposits should not fall below 1.25 percent. In 1979, the ratio fell below 1.25 percent and repayments were suspended.

By 1984, the reserve/deposit ratio had fallen to 0.53 percent, and on March 31, 1985, an additional special insurance premium of 1/8 of one percent was levied on total deposits of the FSLIC insured institutions.

Table 1 provides a summary of the legislation that altered the basic insurance coverage and the actual and the effective insurance premia for the FSLIC and the FDIC.

Chart 1 graphs the effective premium for both the FSLIC and the FDIC and Chart 2 graphs the basic deposit insurance coverage for the period 1935-1988. In the case of the FSLIC, the actual primary reserve premium is the effective premium. For the FDIC, the effective and actual premiums coincide until 1950 when rebating was initiated. Since 1950, the FDIC has been required by law to rebate a percentage of its net assessment income, defined as the current year's assessment income minus all costs incurred that year and any depletion of the insurance reserve fund that occurred in earlier years.

To determine the effective premium, the following method was used. First we calculated yearly net assessment income, which equals

Table 1

History of Federal Deposit Insurance Premiums and Coverage

FSLIC

June 27, 1934 National Housing Act	Annual premium is set at 1/4 of 1 percent of the total amount of all accounts at insured institutions plus any creditor obligations. Premium is to be assessed annually until a reserve fund equal to 5 percent of all accounts plus creditor obligations is established. An emergency assessment ability of an additional 1/4 of 1 percent per annum is available if so needed to meet the expenses of the corporation. Basic insurance coverge is set at $5,000 per depositor per insured institution.
May 28, 1935 An Act to Provide Additional Home-Mortgage Relief	The premium is reduced to 1/8 of 1 percent. The maximum special assessment is reduced to 1/8 of 1 percent.
June 27, 1950 Amendment to the National Housing Act	The premium is reduced to 1/12 of 1 percent. Elimination of the special assessment is proposed; however, the maximum special assessment remains 1/8 of 1 percent. A line of credit with the Treasury is established, the maximum amount borrowable in an emergency is $750 million. Basic insurance coverage is set at $10,000 per individual depositor.
September 8, 1961 Amendment to the National Housing Act	Establishment of the Secondary Reserve, a prepayment reserve with a 2 percent annual assessment on anticipated net increases in total deposits.

FDIC

June 16, 1933 The Banking Act of 1933	The premium is set at 1/2 of 1 percent of total insured deposits. One half of total assessment is to be paid in full upon admission to the fund, the remainder subject to call. The ability to assess an emergency sum was not to exceed the amount already paid in for that year, for a possible maximum special assessment of 1/2 of 1 percent of the total insured deposits. Basic insurance coverage is set at $2,500 per depositor per insured institution.
August 23, 1935 Banking Act of 1935	The premium is assessed on total domestic deposits and reduced to 1/12 of 1 percent per annum. Maximum emergency borrowings from Treasury are $975 million, and emergency assessment rights are eliminated.
August 5, 1947 Banking Act of 1935	The line of credit at Treasury is increased to $3 billion.
September 21, 1950 The Federal Deposit Insurance Act	Premium rebates equal to 60 percent of net assessment income are established. Basic insurance coverage is raised to $10,000 per individual depositor.
July 14, 1960 Amendment to the Federal Deposit Insurance Act	Rebates increased to 66.66 percent of net assessment income.

Table 1 (continued)

October 16, 1966 Financial Institutions Supervisory Act	Basic insurance coverage raised to $15,000 per individual depositor.	October 16, 1966 Financial Institutions Supervisory Act	Basic insurance coverage is raised to $15,000 per individual depositor.
December 23, 1969 Credit Control Act	Basic insurance coverge raised to $20,000 per individual depositor.	December 23, 1969 Credit Control Act	Basic insurance coverage is raised to $20,000 per individual depositor.
August 16, 1973 Amendment to the National Housing Act	Eliminates payments into the prepayment reserve, the Secondary Reserve.		
October 28, 1974 Act of October 28, 1974	Basic insurance coverage raised to $40,000 per individual depositor.	October 28, 1974 Act of October 28, 1974	Basic insurance coverage raised to $40,000 per individual depositor. Insurance limit for time and savings accounts held by state and political subdivisions is increased to $100,000.
		November 10, 1978 Financial Institutions Regulatory and Interest Rate Act of 1978	Insurance limit for Individual Retirement (IRA) and Keogh Accounts is raised to $100,000.
March 31, 1980 Depository Institutions Deregulation and Monetary Control Act	Basic insurance coverage raised to $100,000 per individual depositor.	March 31, 1980 Depository Institutions Deregulation and Monetary Control Act	Rebates decreased to 60 percent of net assessment income. Basic insurance coverage is raised to $100,000 per individual depositor.
March 31, 1985	The Bank Board levied a special assessment (1/8 of 1 percent annually) against FSLIC-insured institutions for the first time.		

CHART 1
EFFECTIVE INSURANCE PREMIUMS
1934-1987

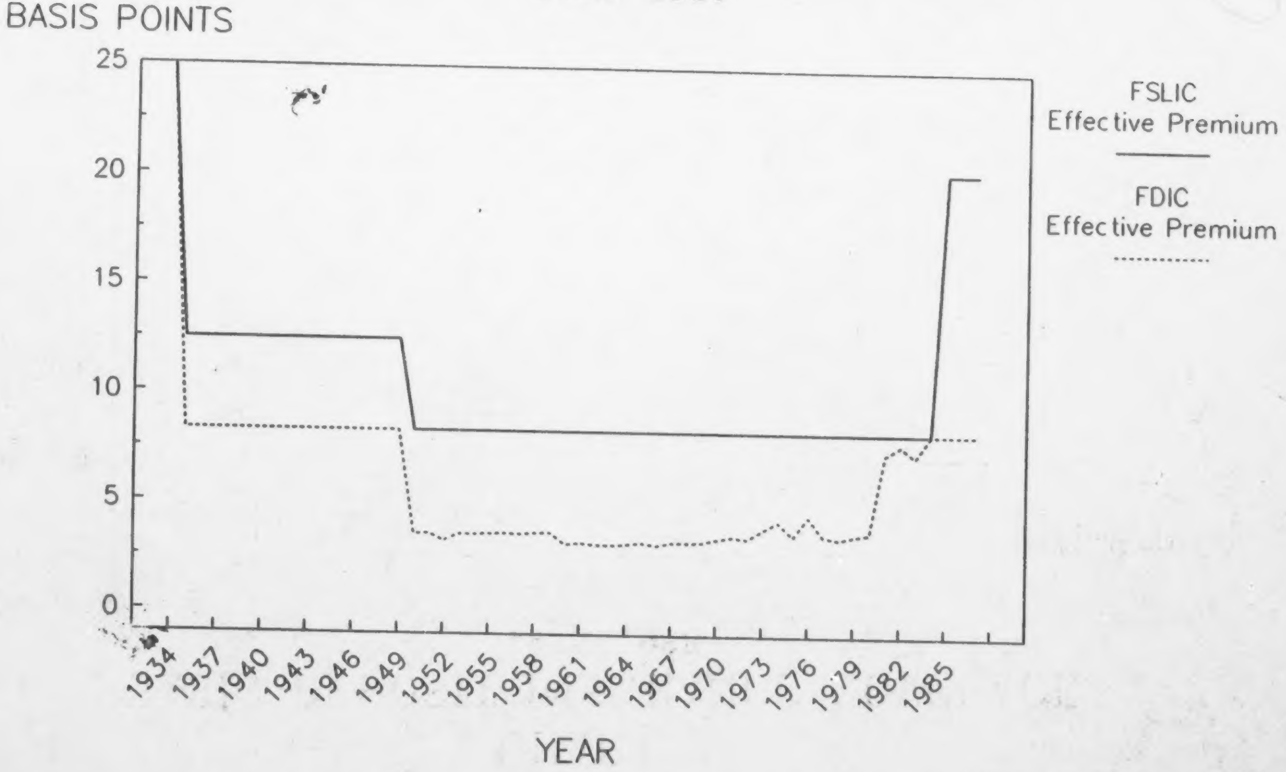
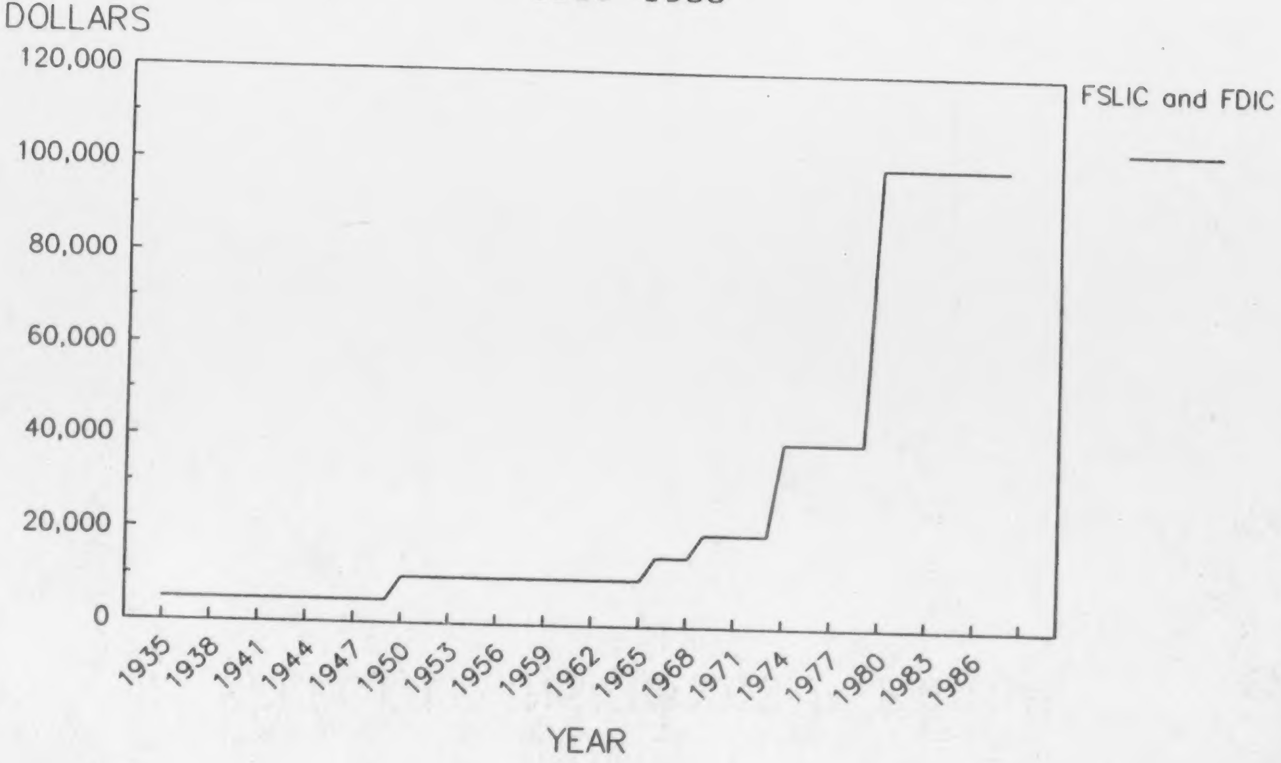


CHART 2
BASIC DEPOSIT INSURANCE COVERAGE
1935–1988



yearly assessment income minus all current and carried costs. Then we calculated the percentage of assessment income rebated, which equals the rebate percentage times the year's net assessment income. To arrive at the percentage of assessment income retained by the FDIC for the year, we subtracted the percentage of assessment income rebated from one. Finally, the effective premium was determined by multiplying the actual premium by the percentage of assessment income kept by the FDIC for the year.[1]

II. Historical Trends

In this section, various statistics for banks and thrifts for the period 1934 to 1987 are presented, including the percent of institutions that became insolvent and were resolved, losses per 100 dollars of assets of resolved insolvencies, percent of all assets held by failed institutions, losses per 100 dollars of deposits of all institutions, and the number of insured financial institutions.[2]

Charts 3 and 4 show that before 1980, the highest level of thrift failures as a percent of all thrifts was 0.55 percent in 1940. In 1982, the figure had jumped to 1.97 percent. By 1987, the figure had dropped to 1.49 percent; still well over twice as high as the pre-1980 peak. The other charts also show how bad the failures of those

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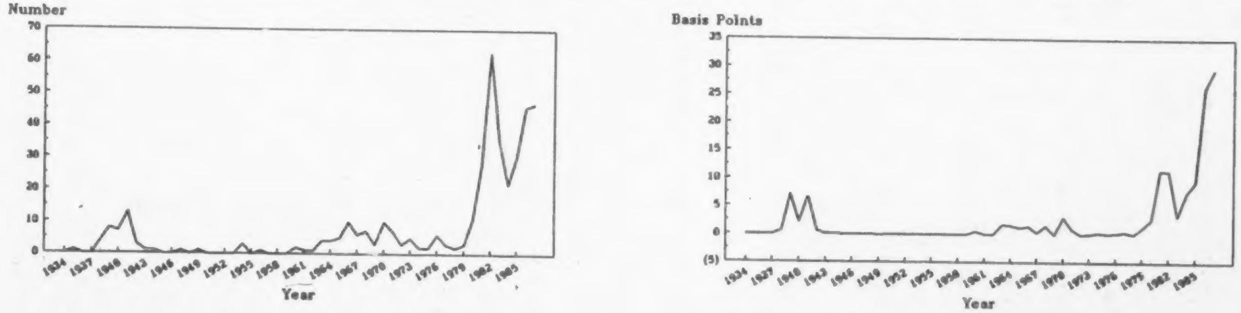
[1] The data used for the calculation were obtained from the 1987 Annual Report of the FDIC. The data are from Table 125, p. 62 and are assessment income and total expenses and losses for the years 1950-1987. All percentages are expressed in their decimal equivalents for the purposes of the calculation.

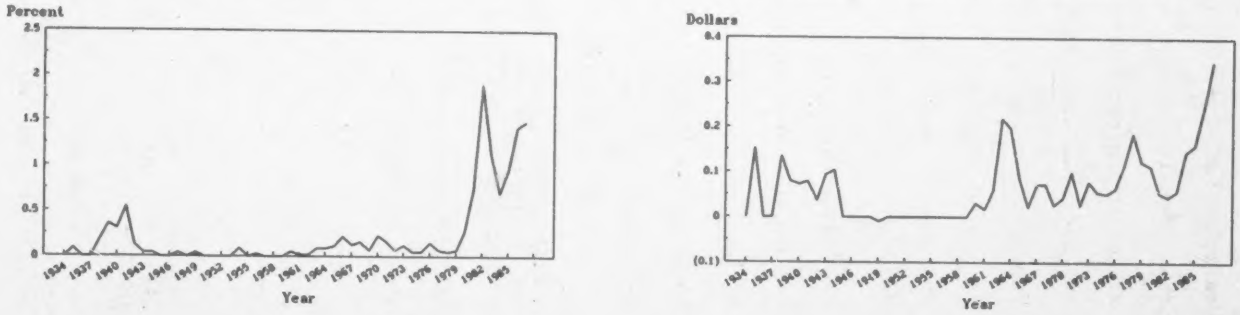
[2] The FDIC data are obtained from the FDIC 1987 Annual Report, Table 125, p. 61, losses for all cases 1934-1987. The totals for 1986 and 1987 do not include open bank assistance cases.

Chart 3
Thrift Industry Historical Perspective
1934–1987



Number of Insured Thrift Failures

Losses per Asset Dollar of All Thrifts

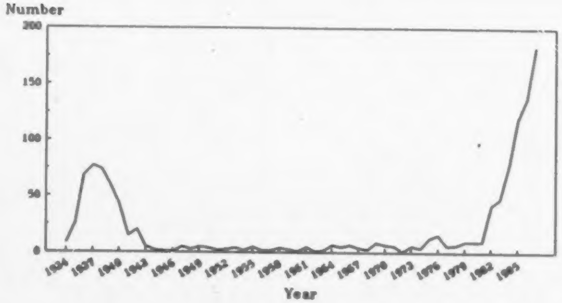


Percent of Thrift Institutions that Failed

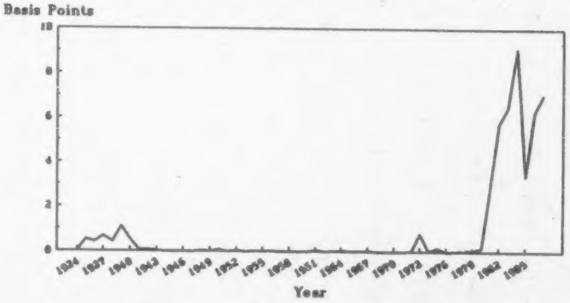
FSLIC Losses per Asset Dollar of Failed Thrifts

Chart 4
Bank Industry Historical Perspective
1934–1987

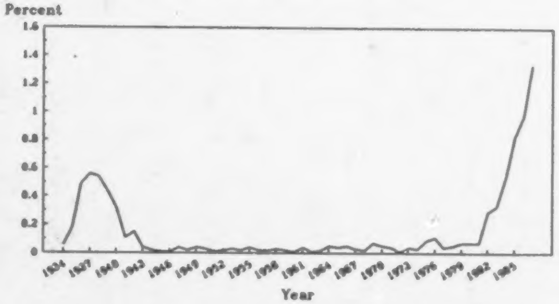
Number of Banks that Failed



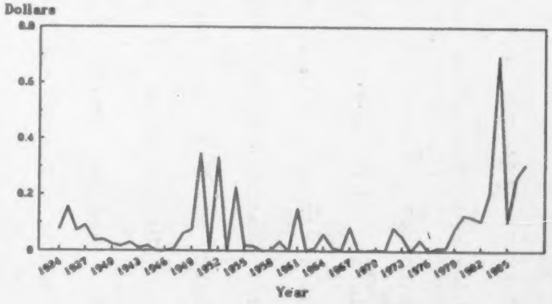
Losses per Asset Dollar of All Banks



Percent of Banks that Failed



FDIC Losses per Asset Dollar of Failed Banks



institutions have been. The top graph (Losses per Asset Dollar of All Thrifts) indicates how much the failures were spread throughout the industry. The bottom graph (Losses per Asset Dollar of Failed Thrifts) indicates how much the failures cost as a percentage of the failures' sizes. This reflects the poorer asset quality of failures in recent years compared with previous periods. Once again, we see peaks after 1980 that dwarf earlier highs. All four graphs on each of these two charts point out how serious the crisis has become.

The severity of thrift and bank losses can be compared by examining the number of failures as a percentage of all firms in their respective industries. In Chart 5 we observe that thrifts have usually had a greater portion of their industry participants fail in most years since the mid-1960s. Part of this difference is attributed to the fact that there are fewer thrifts than banks (see Chart 6).

One striking difference between banks and thrifts is displayed in Chart 5, where it may be seen that during the period of high and volatile interest rates, in the early 1980s the proportion of thrifts that failed is significantly larger than the proportion of commercial banks that failed. Failed institutions in this period accounted for more than 2.5 percent of all thrift assets compared with less than 0.55 percent for FDIC-insured failures see (Chart 7). After 1982, the percentage of thrifts and banks that failed is once again roughly the same.

When failures are examined to determine the quality of assets of failed institutions, one finds that the FDIC has often incurred a greater resolution cost per asset dollar than the FSLIC (see Chart 8).

Chart 5
Percent of Institutions that Failed
1934–1987

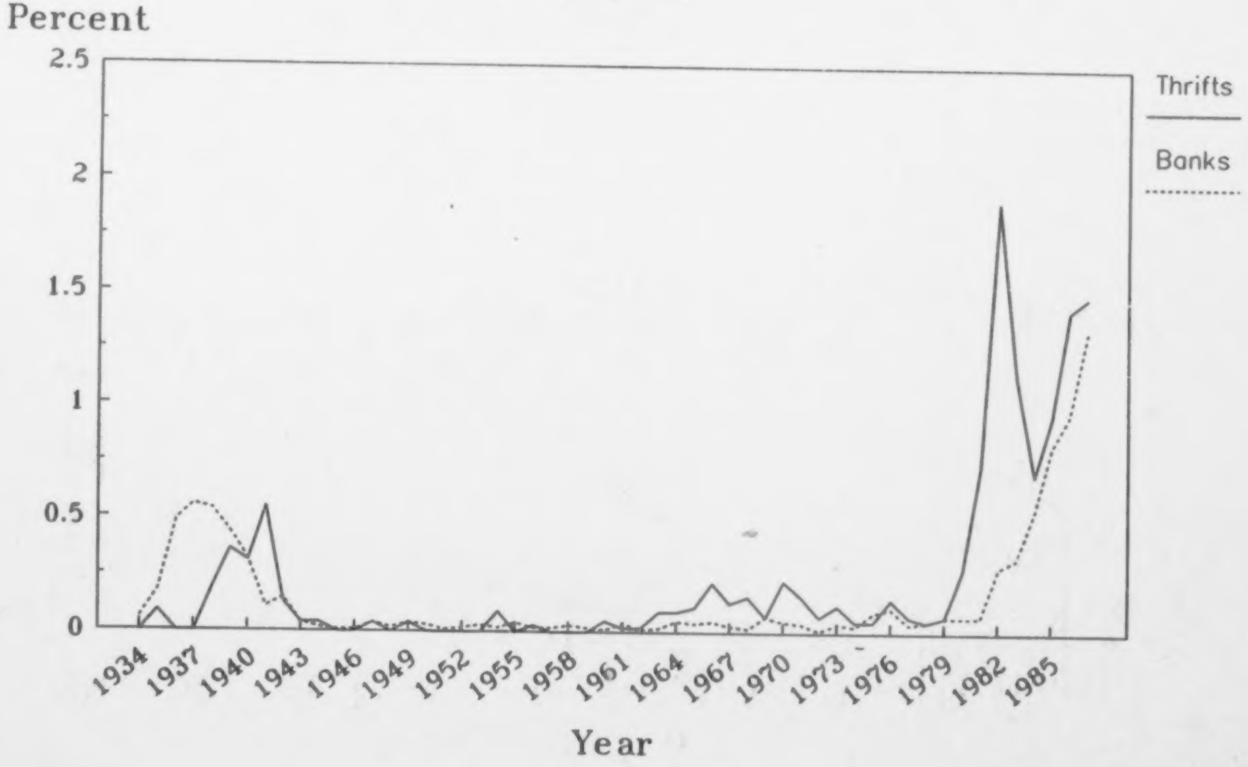
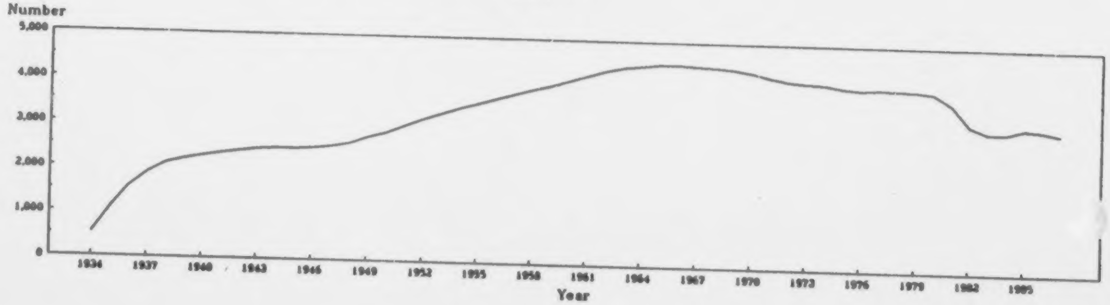


Chart 6
Number of Insured Financial Institutions
1934-1987

Thrifts



Banks

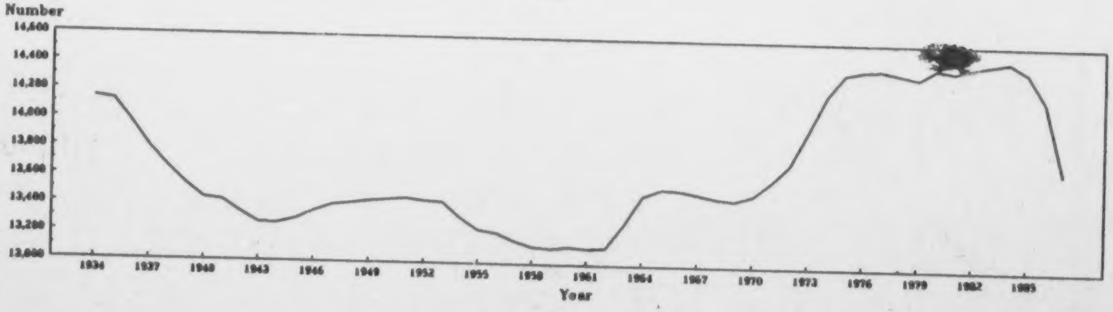


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Chart 7
Percent of Assets Held by Failed Institutions
1934-1987

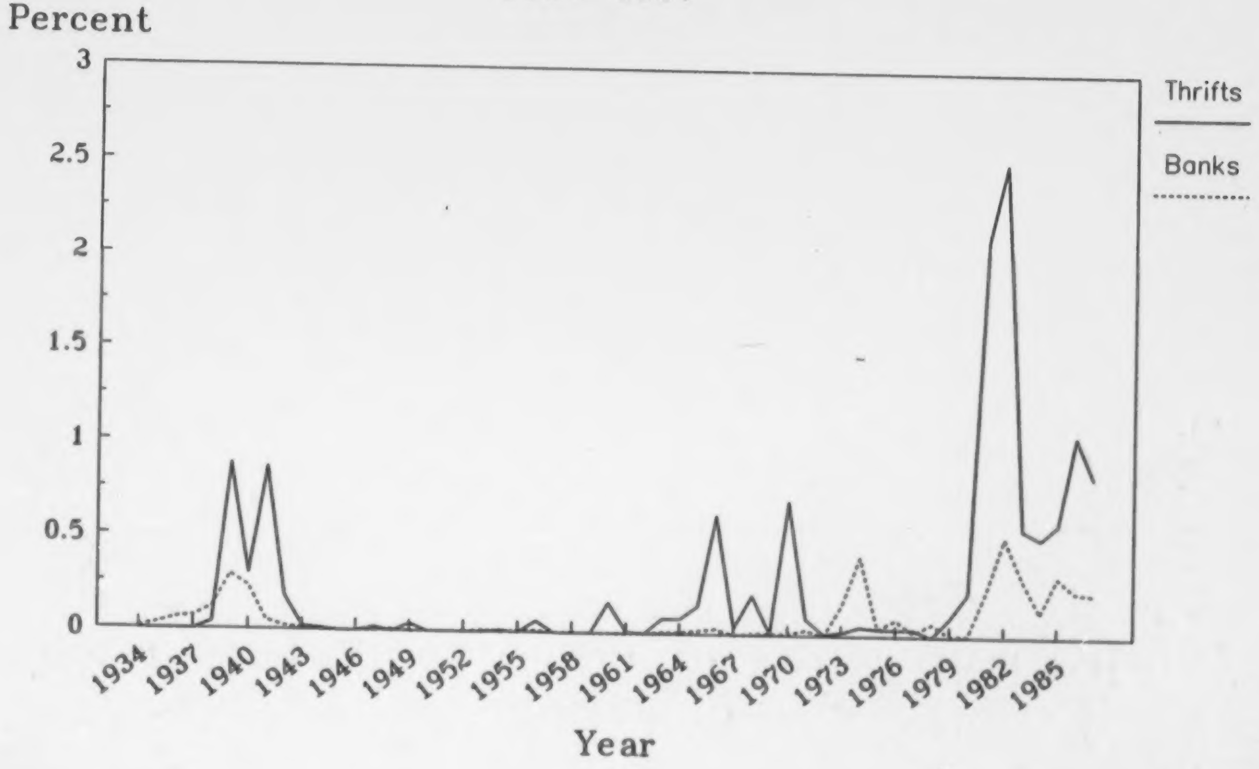
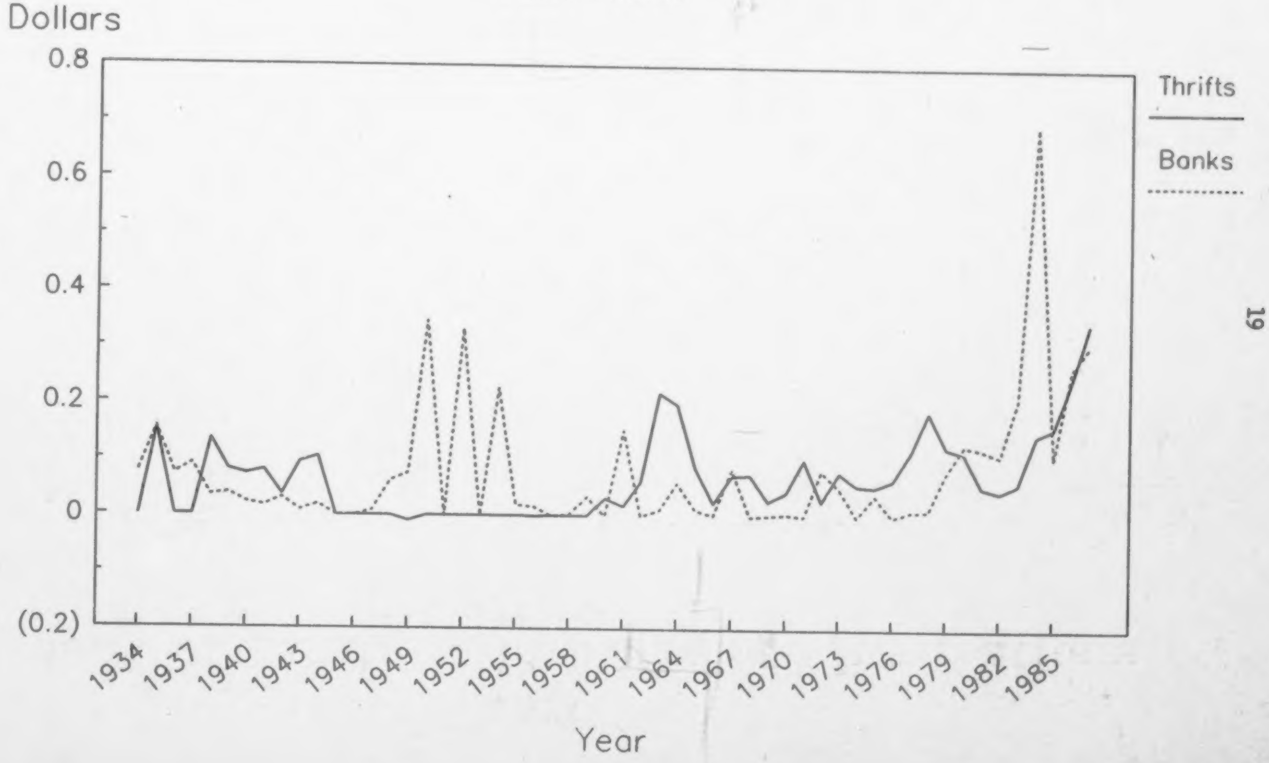


Chart 8
Losses Per Asset Dollar of Failed Institutions
1934-1987



This chart compares how costly each industry's failures were to the insurer by comparing the cost of failure resolution to the failures' assets. Since 1979, the chart shows that, on average, failed banks have had poorer quality assets than failed thrifts (until 1986). This measure of asset quality for both industries is currently at historically high levels.

III. Loss Experience and the Reserve Coverage Ratio

In this section, the evolution of the reserve coverage ratio for the FSLIC and the FDIC is discussed. The coverage ratio, the ratio of insurance fund reserves to insured deposits, is a summary measure of a deposit insurance fund's ability to cover the costs of resolving failed institutions. It should be noted that for the FSLIC, the targeted coverage ratio (legislated) for primary reserves has never been below 2 percent.[3] However, the coverage ratio for FSLIC primary reserves has always been below the coverage ratio for the FDIC and *ex post* never even approached the 2 percent level. Premium reductions and the creation of a prepayment reserve, which masked the level of the primary reserve coverage ratio, precluded the increase in the FSLIC's coverage ratio from exceeding the FDIC's, despite greater average losses per deposit dollar for the FSLIC.

The coverage ratio is graphed in Chart 9. As may be seen, the coverage ratio for the FDIC has been relatively stable since the repayment of the initial funding of the FDIC provided by the Treasury

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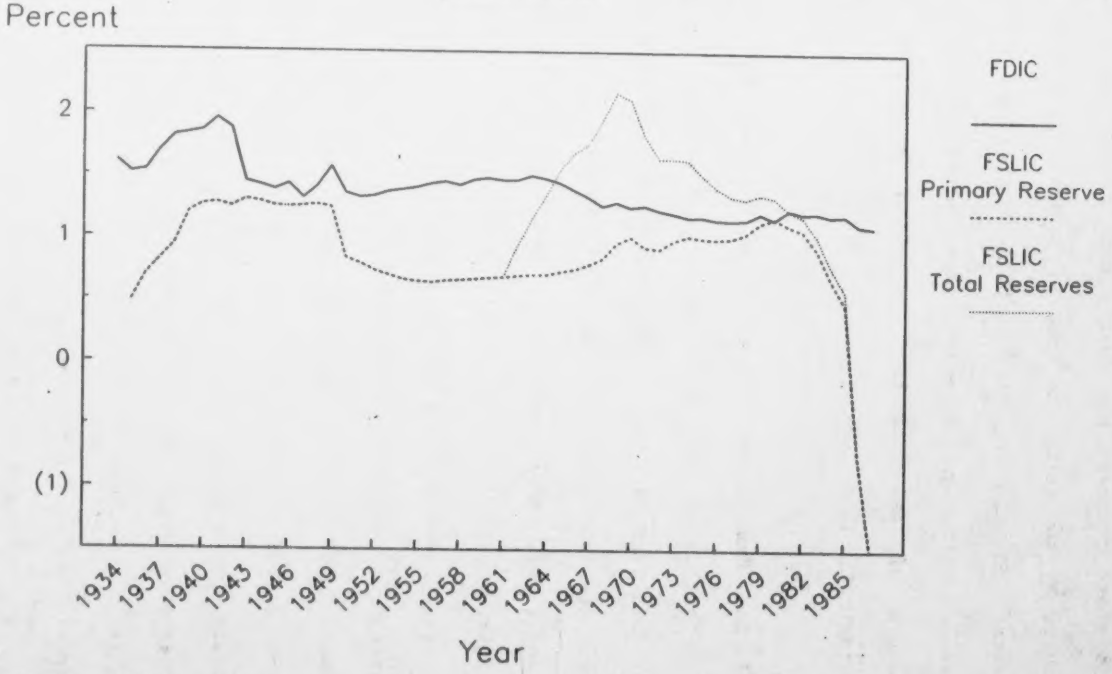
[3] The legislated ratio for the FSLIC has been the insurance fund reserves to insured deposits, which is never larger than the coverage ratio.

CHART 9
COVERAGE RATIO:
INSURANCE FUND RESERVES/INSURED DEPOSITS
1934-1987



Total Reserves equal Primary plus Secondary.

and the Federal Reserve Banks in the late 1940s and the establishment of the premium rebate system in 1950. The premium rebate system responded automatically to increased costs to the FDIC, smoothing the coverage ratio over time. This stabilization mechanism--combined with (1) low variability in the cost of resolving insolvent institutions (see Chart 10) and (2) low (relative to the FSLIC) variability of the percentage rate of growth of insured deposits--has led to the low volatility of the coverage ratio for the FDIC. The performance of this mechanism has been so smooth that, as can be seen from Chart 11, the percentage rate of growth of FDIC insurance fund reserves is nearly a lagged moving average of the rate of growth of insured deposits. That is to say, the fund automatically accumulates during periods of high deposit growth and does not disburse during periods of higher losses. Of course, the efficiency of the mechanism for smoothing variations during periods of relatively low loss experience does not preclude the FDIC from suffering problems similar to the FSLIC during the periods of high resolution cost. More specifically, the coverage ratio for the FDIC may prove to be too low since the FDIC has reached the upper bound of its annual assessment abilities and is reducing its insurance reserve to effect resolution of failed institutions.[4]

The average loss per deposit dollar experience for the FSLIC has been greater than for the FDIC (see Chart 10) and is reflected in the higher premiums assessed thrift institutions (see Chart 1). The average cost per deposit dollar of failures for the entire time period 1934-

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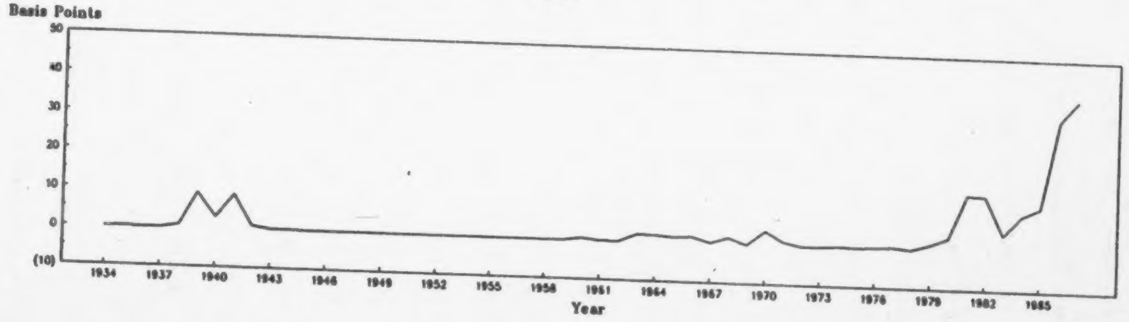
[4] The FDIC, unlike the FSLIC, does not book contingent liabilities for insolvent but unresolved institutions.

CHART 10
Estimated Present Value Cost of Resolving Insolvent Institutions Per Dollar of Total Deposits at All Insured Institutions
1934-1987

FSLIC



FDIC

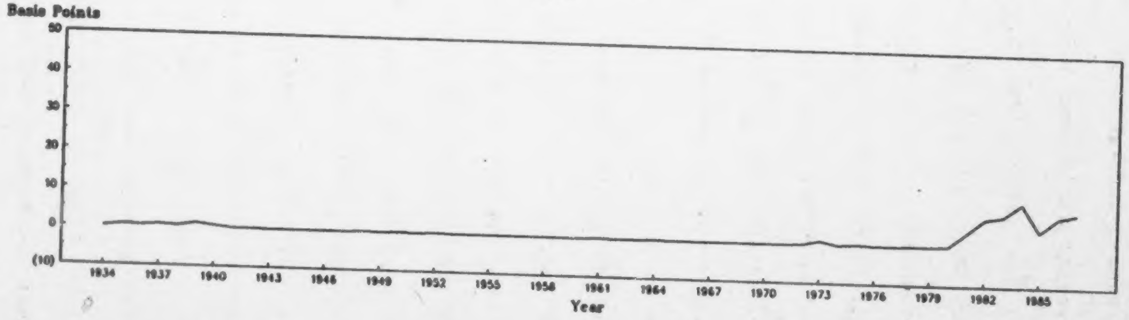
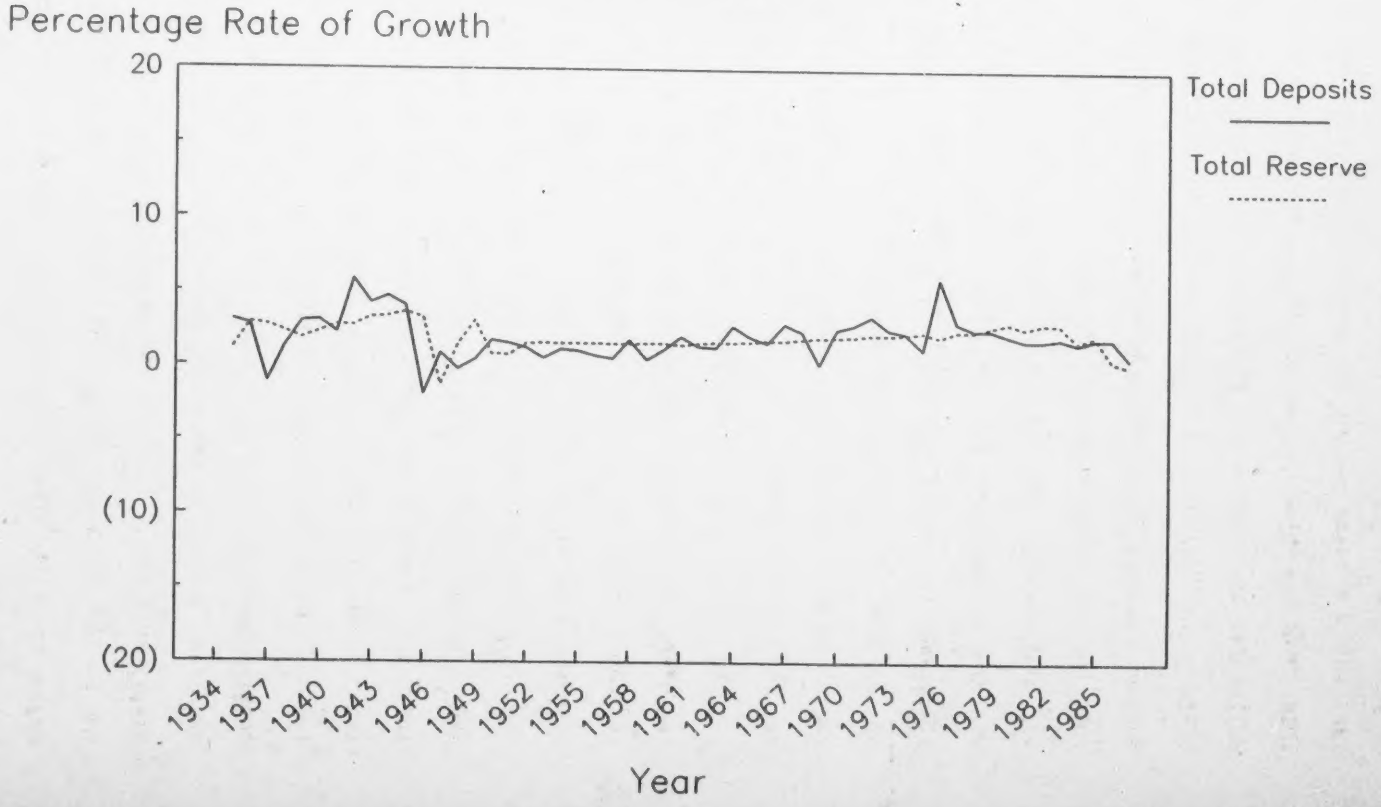


CHART 11
FDIC RESERVE AND INSURED INSTITUTION DEPOSITS
PERCENTAGE RATES OF GROWTH
1934–1987

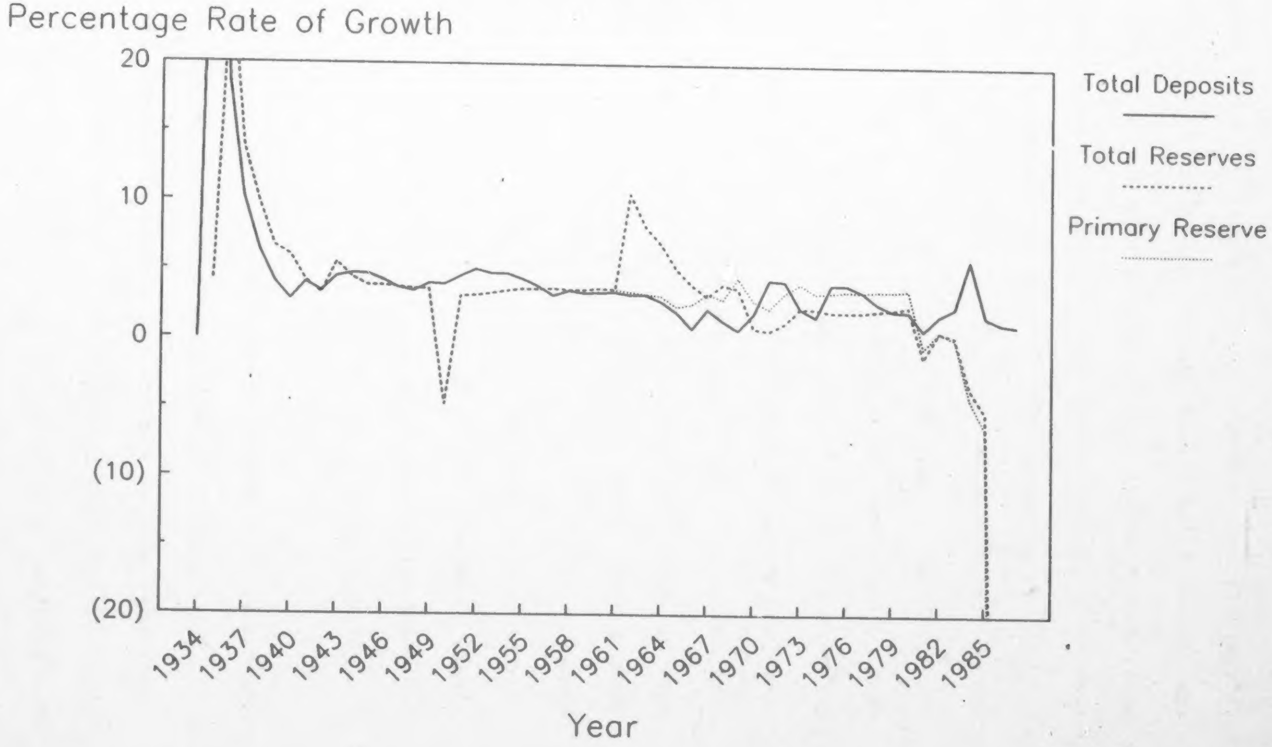


1987 was 3.2 basis points for the FSLIC and 1.1 basis points for the FDIC. For the time period 1934-1979, the average cost per deposit dollar for the FSLIC was 0.89 basis points per deposit dollar and 0.14 basis points per deposit dollar for the FDIC. Clearly, the loss data suggest that the FSLIC should have had a higher coverage ratio than the FDIC for the entire time period, implying an even higher premium than was historically assessed. Exacerbating the early low coverage ratio was the decision to cut the FSLIC insurance premium in 1950 while simultaneously repaying a major portion of the initial capitalization of the fund to the Treasury. As may be seen in Chart 9, the coverage ratio dropped precipitously and, until 1960, nothing was done to rectify the situation.

In 1961, Congress mandated that the FSLIC should establish a secondary reserve that increased the total reserve coverage ratio. The secondary reserve was a prepayment reserve, that is, it was an assessment on anticipated increases in total deposits. Because of the time lag between when depository institutions take in additional deposits and when deposit insurers actually assess primary deposit insurance, rapid growth of the deposit base may cause the coverage ratio to decline quickly if the percentage rate of growth of deposits is very large and sudden. A secondary reserve is a mechanism for shoring up the coverage ratio for short-term, rapid increases in deposits. After a temporary period of rapid deposit growth, the prepayments are credited to the primary reserve assessment. However, as may be seen in Chart 12, the percentage rate of deposit growth actually began to fall after the imposition of the secondary reserve. In

Chart 12

FSLIC RESERVES AND INSURED INSTITUTION DEPOSITS
PERCENTAGE RATES OF GROWTH
1934–1987



retrospect, it appears that depository institutions, assuming a resurgence of the deposit growth experience of the early fifties, made massive prepayments (anticipated deposit increases were assessed at the rate of 2 percent rather than the standard assessment of 1/12 of one percent) relative to their primary assessments and the rate of growth of the total reserve accelerated rapidly. Once the ratio of total reserves to total deposits reached 2 percent, the depository institution's secondary reserve contribution plus accrued interest were credited to its primary reserve assessment, subject to the caveats specified by the legislation. Had the current problems occurred in the late 1960s or early 1970s, when the total reserve coverage ratio was near or above the 2 percent level, the FSLIC would certainly have been in a better position to resolve insolvent institutions in a timely manner.

As may be seen from Chart 9, the primary reserve coverage ratio slowly increased over this entire time period. However, the law still envisioned a 2 percent ratio of primary reserves to total deposits as its ultimate goal, a goal that was never reached.

IV. Alternative Premium Assessments

This section describes the potential size of the FSLIC insurance fund under several alternative premium assessment regimes. The size of the insurance fund is calculated assuming that (1) premiums were set at the original 1934 level of 25 basis points and (2) at 32 basis points (the average loss per depositor dollar at commercial banks reported by Crowley before Congress in 1935). To do this, we construct a time series on the hypothetical dollar value of the fund from 1935 until the present. We find that either of these assessment regimes would have resulted in the FSLIC remaining solvent through 1987, inclusive of all contingent liabilities that were booked.

The time series on the size of the FSLIC insurance fund is obtained as follows.

TD_t = Total Deposits,

IP_t = Primary Insurance Premium,

FC_t = FSLIC Costs,

NI_t = Net Annual Income,

TF_t = Total Insurance Fund, and

$AGR_{t,s}$ = Geometric Average Rate of Return of the Insurance Fund between t and s

$$AGR_{t,s} = \left[\prod_{j=1}^{s-1} (1+r_j) \right]^{(s-1)^{-1}} - 1$$

where t and s denote time periods.

Net income for the year equals the insurance premium assessed on total deposits times the amount of total deposits at insured institutions minus FSLIC costs for the year. More formally,

$$NI_t = (IP_t)(TD_t) - FC_t. \qquad (1)$$

The total dollar value of the fund n periods after the first assessment at time t, TF_{t+n}, is given by the following formula,

$$TF_{t+n} = \sum_{i=0}^{N} NI_{t+n-i} \; (1+ AGR_{t+n-i,t+n})^{i}. \qquad (2)$$

This formulation allows us to calculate the hypothetical total dollar value of the insurance fund reserve at the end of each year for any insurance premium. It is assumed that the insurance fund administrators invest the present year's net income plus the total fund carried over from the previous year's investment. It is further assumed that the rate of growth of the fund is 4 percent per annum.[5] This is shown in Chart 13.[6]

The exercise presupposes that the number of insured institutions would have remained the same under any of the assessment rates. Relaxation of this assumption, although desirable, would require knowledge of the elasticity of demand for the insurance services of the FSLIC at each point in time, which is unavailable.

Charts 14 and 15 display the results of our alternative premium regime estimation. Had a 32-basis-point or a 25-basis-point premium been assessed on FSLIC-insured institutions, instead of the historical premiums, the FSLIC's reserve position would be much different today. Although no one can say with certainty that the FSLIC would have been solvent at the end of 1987 had either of these premia prevailed, the funds available for the resolution of insolvent institutions would have been far greater than under the historical premiums. Additional funds would have enabled the FSLIC to resolve insolvent institutions in a more timely fashion, eliminating losses that occurred when institutions that should have been resolved remained open.

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[5] We chose 4 percent as an average annual simple interest rate because of the closeness of our constructed time series (using our methodology and the historic premiums) to the actual value of the FSLIC insurance fund over the relevant time period. This is done because we lack data on the administrative costs incurred by the FSLIC over the period. Similar calculations using one-year Treasury rates for the same period severely overestimated the size of the actual FSLIC insurance fund in the early 1980s.

[6] Figures used in creating Chart 13 include the actual values of the secondary reserve in addition to the estimated income generated by the historic premium. The 25- and 32-basis-point simulations did not.

Chart 13

ALTERNATIVE DEPOSIT PREMIUM REGIMES

Actual versus Estimated FSLIC Reserves
Actual Premium

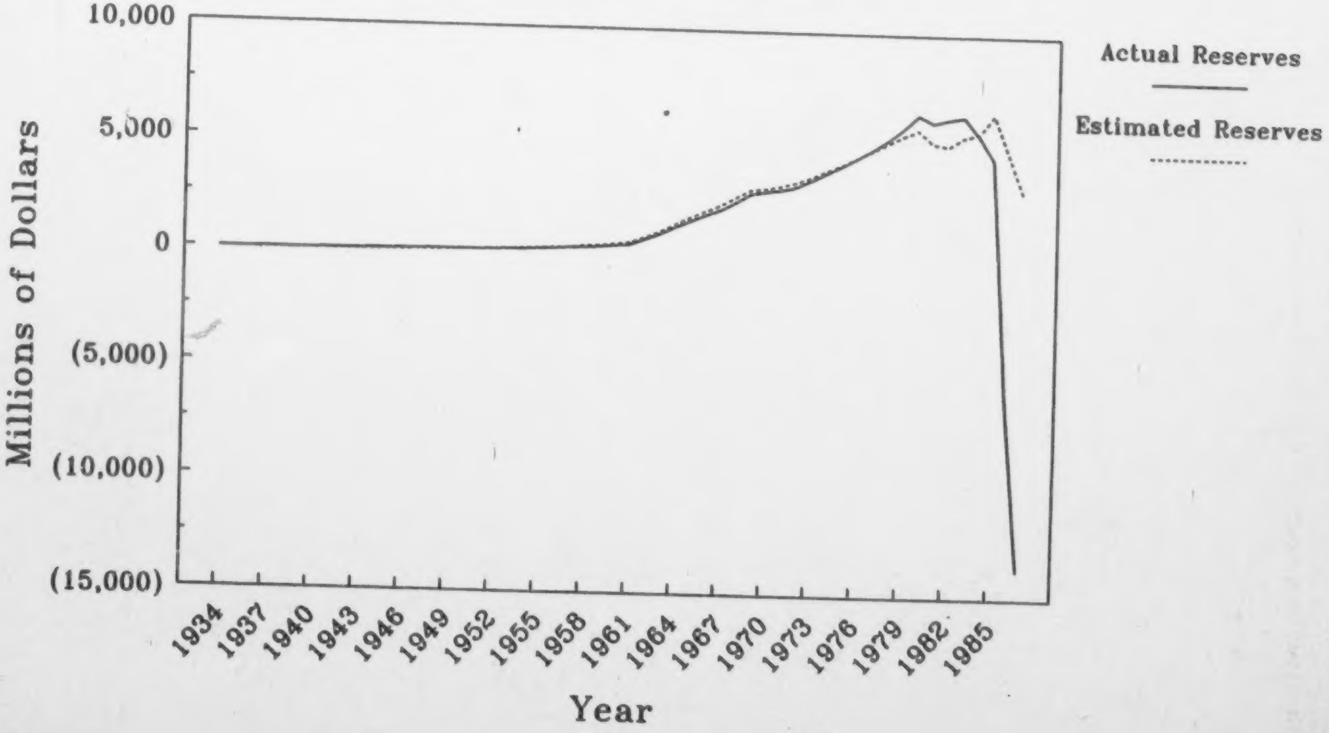


Chart 14

ALTERNATIVE DEPOSIT PREMIUM REGIMES

Actual versus Estimated FSLIC Reserves
25 Basis Point Premium

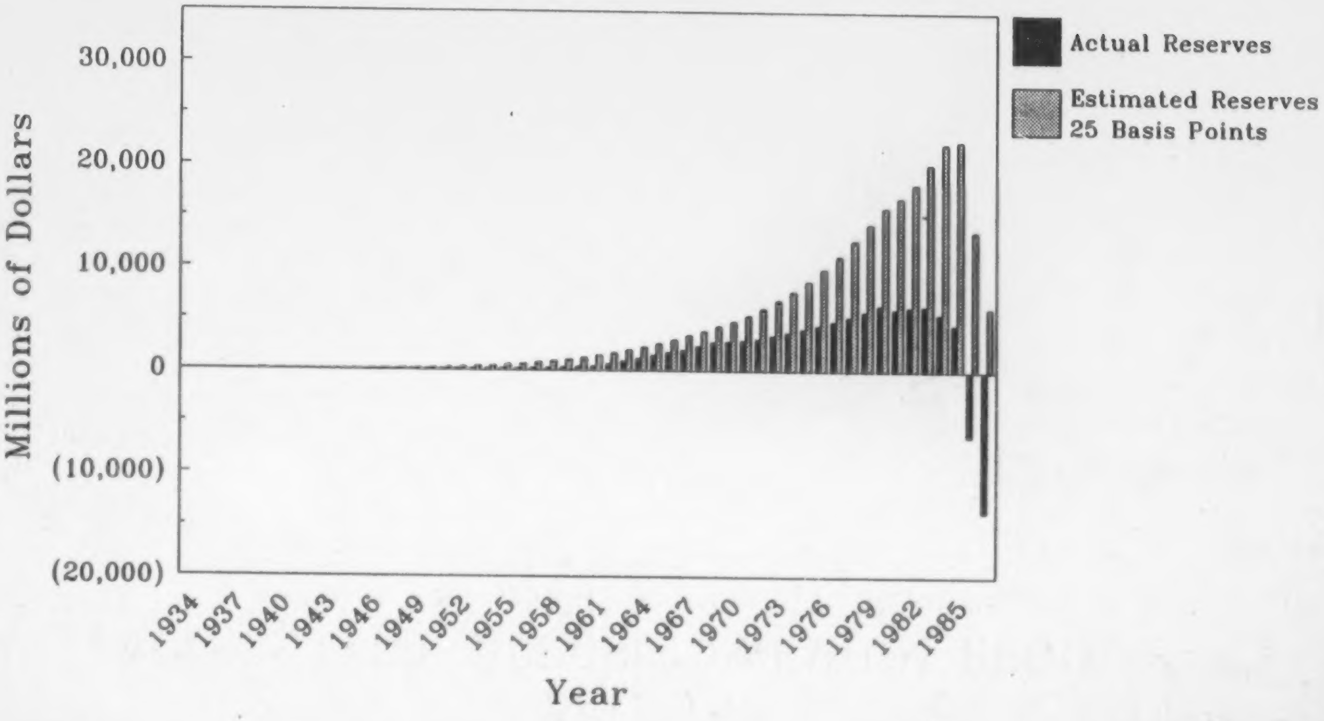
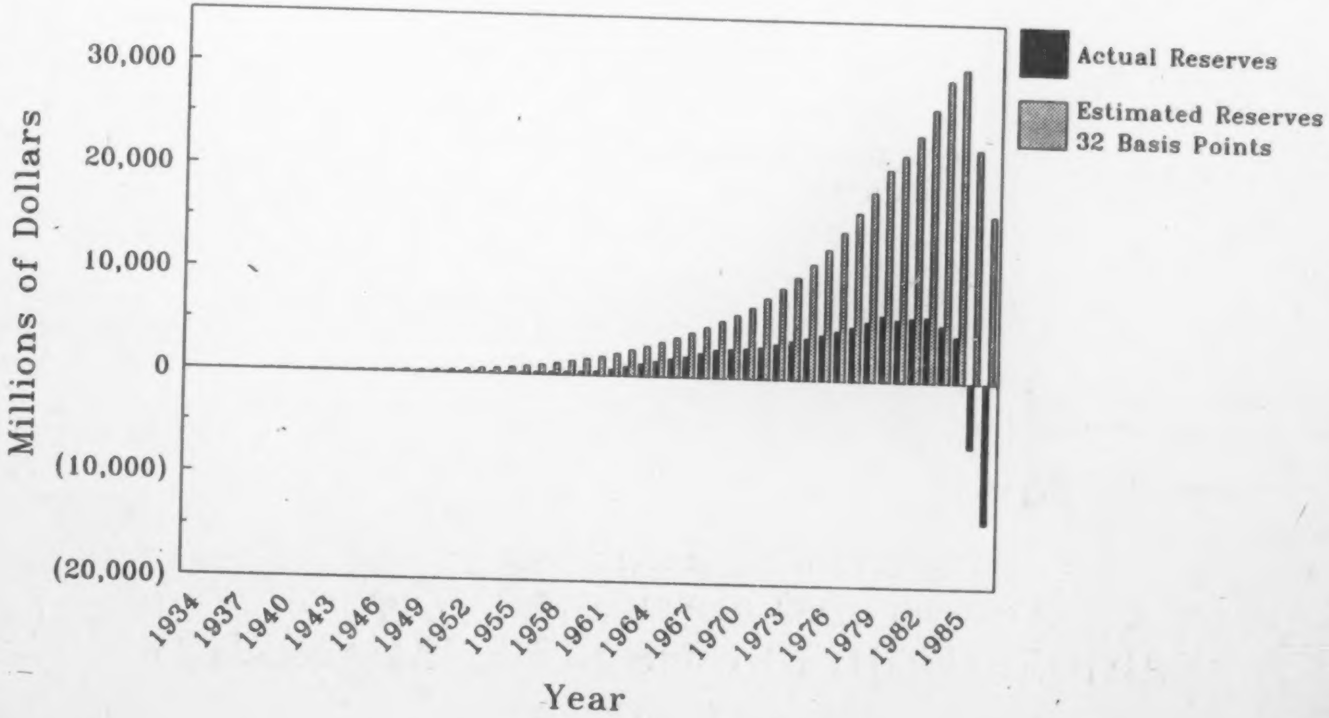


Chart 15
ALTERNATIVE DEPOSIT PREMIUM REGIMES
Actual versus Estimated FSLIC Reserves
32 Basis Point Premium



Thrift Failures: A Historical Perspective

Year	Number of Insured Failures (1)	Number of Insured Institutions (2)	Percent of Institutions that Failed (3)=(1)/(2)	Assets of Failed Institutions ($Thousands) (4)	Assets of all Institutions ($Millions) (5)	Percent of Assets Held by Failed Institutions (6)=(4)/(5)	Insured Deposits of all Thrifts ($Millions) (7)	Total Deposits at Insured Thrifts ($Millions) (8)
1934	0	541	0.00	0	150	0.00	N/A	N/A
1935	1	1,117	0.09	13	711	0.00	N/A	387
1936	0	1,575	0.00	0	1,281	0.00	N/A	853
1937	0	1,884	0.00	0	1,758	0.00	N/A	1,291
1938	4	2,098	0.19	914	2,127	0.04	N/A	1,669
1939	8	2,199	0.36	22,143	2,511	0.88	1,716	1,969
1940	7	2,277	0.31	8,785	2,926	0.30	2,082	2,207
1941	13	2,343	0.55	28,926	3,353	0.86	2,445	2,599
1942	3	2,398	0.13	6,434	3,643	0.18	2,855	2,982
1943	1	2,447	0.04	635	4,173	0.02	3,417	3,571
1944	1	2,466	0.04	268	4,995	0.01	4,137	4,319
1945	0	2,475	0.00	0	6,123	0.00	4,941	5,211
1946	0	2,496	0.00	0	7,294	0.00	5,811	6,184
1947	1	2,536	0.04	1,842	8,528	0.02	6,712	7,177
1948	0	2,616	0.00	0	9,715	0.00	7,716	8,255
1949	1	2,756	0.04	4,684	11,278	0.04	9,064	9,700
1950	0	2,860	0.00	0	13,691	0.00	11,158	11,374
1951	0	3,020	0.00	0	16,204	0.00	13,323	13,653
1952	0	3,172	0.00	0	19,656	0.00	16,271	16,732
1953	0	3,304	0.00	0	23,593	0.00	19,587	20,252
1954	3	3,433	0.09	1,959	28,367	0.01	23,746	24,529
1955	0	3,544	0.00	0	34,198	0.00	28,145	29,241
1956	1	3,666	0.03	22,470	39,338	0.06	32,875	34,152
1957	0	3,772	0.00	0	44,459	0.00	37,334	38,773
1958	0	3,881	0.00	0	51,311	0.00	42,722	44,670
1959	0	3,979	0.00	0	59,550	0.00	48,797	51,160
1960	2	4,098	0.05	110,361	67,430	0.16	55,808	58,662
1961	1	4,221	0.02	10,610	77,984	0.01	64,139	67,312
1962	1	4,332	0.02	2,790	89,545	0.00	72,535	76,743
1963	4	4,419	0.09	79,564	103,154	0.08	82,048	87,526
1964	4	4,463	0.09	93,936	114,652	0.08	92,870	97,861
1965	5	4,508	0.11	180,792	124,576	0.15	99,052	106,103
1966	10	4,510	0.22	813,790	129,045	0.63	106,955	109,772
1967	6	4,487	0.13	56,540	138,489	0.04	116,562	120,184
1968	7	4,470	0.16	305,314	147,736	0.21	123,184	127,264
1969	3	4,438	0.07	16,942	156,788	0.01	128,883	130,995
1970	10	4,365	0.23	1,213,029	170,645	0.71	137,146	141,703
1971	7	4,271	0.16	187,063	199,984	0.09	163,450	169,045
1972	3	4,191	0.07	26,305	236,349	0.01	190,942	200,970
1973	5	4,163	0.12	47,763	264,797	0.02	209,979	220,893
1974	2	4,141	0.05	156,890	288,223	0.05	232,336	236,689
1975	2	4,078	0.05	119,389	330,259	0.04	271,451	278,774
1976	6	4,044	0.15	148,097	383,172	0.04	316,700	328,214
1977	3	4,065	0.07	187,052	449,798	0.04	362,816	378,782
1978	2	4,053	0.05	23,096	513,310	0.00	402,541	422,194
1979	3	4,039	0.07	579,921	568,107	0.10	430,294	460,694
1980	11 *	3,998	0.28	1,457,646 *	620,626	0.23	483,030	503,156
1981	28 *	3,757	0.75	13,908,159 *	658,528	2.11	498,100	519,937
1982	63 *	3,295	1.91	17,662,142 *	699,522	2.52	534,120	560,461
1983	36 *	3,146	1.14	4,631,055 *	819,168	0.57	626,097	671,058
1984	22 *	3,136	0.70	5,080,209 *	977,451	0.52	719,592	784,468
1985	31 *	3,246	0.96	6,368,270 *	1,070,012	0.60	780,473	843,932
1986	46 *	3,220	1.43	12,455,058 *	1,163,851	1.07	823,626	890,664
1987	47 *	3,147	1.49	10,660,360 *	1,250,855	0.85	855,286	932,616

* After 1980, only FSLIC-assisted mergers and liquidations are included. Before that, supervisory cases are included as well.

Thrift Failures: A Historical Perspective

Year	FSLIC Losses ($Thousands) (9)	Losses per Dollar Deposit Dollars of all Thrifts (Basis Points) (10)=(9)/(8)	Losses per Asset Dollar of all Thrifts (Basis Points) (11)=(9)/(5)	Losses per Asset Dollar of Failed Thrifts (12)=(9)/(4)	Premium Per Dollar Total Deposits (Basis Points) (13)	Primary Reserves ($Millions) (14)	Secondary Reserves ($Millions) (15)	Total Reserves ($Millions) (16) = (14)+(15)
1934	0	N/A	0.00	0.0000	25.00	2	0	2
1935	2	0.05	0.03	0.1538	12.50	2	0	2
1936	0	0.00	0.00	0.0000	12.50	6	0	6
1937	0	0.00	0.00	0.0000	12.50	11	0	11
1938	124	0.74	0.58	0.1357	12.50	16	0	16
1939	1,791	9.09	7.13	0.0809	12.50	21	0	21
1940	642	2.91	2.19	0.0731	12.50	26	0	26
1941	2,303	8.86	6.87	0.0796	12.50	31	0	31
1942	238	0.80	0.65	0.0370	12.50	36	0	36
1943	60	0.17	0.14	0.0945	12.50	45	0	45
1944	28	0.06	0.06	0.1045	12.50	53	0	53
1945	0	0.00	0.00	0.0000	12.50	62	0	62
1946	0	0.00	0.00	0.0000	12.50	73	0	73
1947	0	0.00	0.00	0.0000	12.50	85	0	85
1948	0	0.00	0.00	0.0000	12.50	98	0	98
1949	(43)	-0.04	-0.04	-0.0092	12.50	113	0	113
1950	0	0.00	0.00	0.0000	12.50	94	0	94
1951	0	0.00	0.00	0.0000	8.30	106	0	106
1952	0	0.00	0.00	0.0000	8.30	121	0	121
1953	0	0.00	0.00	0.0000	8.30	138	0	138
1954	0	0.00	0.00	0.0000	8.30	159	0	159
1955	0	0.00	0.00	0.0000	8.30	183	0	183
1956	(3)	0.00	0.00	-0.0001	8.30	212	0	212
1957	0	0.00	0.00	0.0000	8.30	246	0	246
1958	0	0.00	0.00	0.0000	8.30	284	0	284
1959	0	0.00	0.00	0.0000	8.30	328	0	328
1960	3,477	0.59	0.52	0.0315	8.30	381	0	381
1961	189	0.03	0.02	0.0178	8.30	441	0	441
1962	171	0.02	0.02	0.0613	8.30	507	171	678
1963	17,431	1.99	1.69	0.2191	8.30	580	365	945
1964	18,652	1.91	1.63	0.1986	8.30	659	590	1,249
1965	15,505	1.46	1.24	0.0858	8.30	725	812	1,537
1966	19,236	1.75	1.49	0.0236	8.30	805	999	1,804
1967	4,087	0.34	0.30	0.0723	8.30	922	1,127	2,049
1968	22,561	1.77	1.53	0.0739	8.30	1,037	1,372	2,409
1969	462	0.04	0.03	0.0273	8.30	1,243	1,558	2,801
1970	53,109	3.75	3.11	0.0438	8.30	1,394	1,509	2,903
1971	18,944	1.12	0.95	0.1013	8.30	1,529	1,458	2,987
1972	722	0.04	0.03	0.0274	8.30	1,758	1,384	3,142
1973	3,782	0.17	0.14	0.0792	8.30	2,076	1,377	3,454
1974	8,720	0.37	0.30	0.0556	8.30	2,382	1,410	3,791
1975	6,311	0.23	0.19	0.0529	8.30	2,740	1,379	4,120
1976	9,599	0.29	0.25	0.0648	8.30	3,167	1,313	4,480
1977	21,727	0.57	0.48	0.1162	8.30	3,653	1,220	4,873
1978	4,320	0.10	0.08	0.1870	8.30	4,228	1,100	5,328
1979	71,961	1.56	1.27	0.1241	8.30	4,891	957	5,848
1980	166,644 *	3.31	2.69	0.1143	8.30	5,670	792	6,462
1981	758,683 *	14.59	11.52	0.0545	8.30	5,557	599	6,156
1982	803,340 *	14.33	11.48	0.0455	8.30	5,717	614	6,331
1983	274,678 *	4.09	3.35	0.0593	8.30	5,764	661	6,425
1984	742,509 *	9.47	7.60	0.1462	8.30	4,885	721	5,606
1985	1,021,655 *	12.11	9.55	0.1604	8.30	3,783	776	4,557
1986	3,065,059 *	34.41	26.34	0.2461	20.80 **	(6,333)	0	(6,333)
1987	3,703,610 *	39.71	29.61	0.3474	20.80 **	(13,690)	0	(13,690)

* After 1980, only FSLIC-assisted mergers and liquidations are included. Before that, supervisory cases are included as well.

** Includes special assessment.

Thrift Failures: A Historical Perspective

Year	Est. Net Income using Actual Primary Prem. Plus Secondary Reserve ($Millions) (17)	Est. Total Reserves Using Actual Primary Premium Plus Secondary Reserve ($Millions) (18)	Net Income from .32% Premium ($Millions) (19)	Total Reserves from .32% Premium Compounded @ 4% ($Millions) (20)	Net Income from .25% Premium ($Millions) (21)	Total Reserves from .25% Premium Compounded @ 4% ($Millions) (22)	Net Income from .125% Premium ($Millions) (23)	Total Reserves from .125% Premium Compounded @ 4% (Millions) (24)
1934	0	2	N/A	0	N/A	0	N/A	0
1935	0	2	1	1	1	1	0	0
1936	1	3	3	4	2	3	1	2
1937	2	5	4	8	3	6	2	3
1938	2	7	5	14	4	11	2	5
1939	1	8	5	19	3	14	1	6
1940	2	11	6	26	5	20	2	9
1941	1	12	6	33	4	25	1	10
1942	3	16	9	44	7	33	3	14
1943	4	21	11	57	9	43	4	19
1944	5	27	14	73	11	56	5	25
1945	7	35	17	93	13	71	7	32
1946	8	44	20	116	15	89	8	41
1947	9	55	23	144	18	111	9	52
1948	10	67	26	176	21	136	10	64
1949	12	82	31	214	24	166	12	79
1950	9	95	36	259	28	201	14	97
1951	11	110	44	313	34	243	17	117
1952	14	128	54	379	42	294	21	143
1953	17	150	65	459	51	357	25	174
1954	20	176	78	556	61	432	31	212
1955	24	208	94	672	73	523	37	257
1956	28	244	109	808	85	629	43	310
1957	32	286	124	964	97	751	48	371
1958	37	335	143	1,146	112	893	56	441
1959	42	391	164	1,355	128	1,056	64	523
1960	45	452	184	1,594	143	1,242	70	614
1961	56	525	215	1,873	168	1,460	84	722
1962	235	781	245	2,193	192	1,710	96	847
1963	242	1,054	263	2,543	201	1,979	92	975
1964	273	1,370	295	2,940	226	2,285	104	1,115
1965	271	1,696	324	3,381	250	2,626	117	1,277
1966	226	1,989	332	3,848	255	2,986	118	1,446
1967	184	2,253	381	4,383	296	3,402	146	1,650
1968	283	2,626	385	4,943	296	3,833	136	1,852
1969	239	2,971	419	5,559	327	4,314	163	2,090
1970	(47)	3,042	400	6,182	301	4,787	124	2,297
1971	10	3,174	522	6,951	404	5,383	192	2,582
1972	34	3,335	642	7,872	502	6,100	250	2,935
1973	117	3,586	703	8,890	548	6,892	272	3,325
1974	165	3,894	749	9,994	583	7,751	287	3,745
1975	139	4,188	886	11,279	691	8,751	342	4,237
1976	141	4,497	1,041	12,771	811	9,912	401	4,807
1977	147	4,824	1,190	14,472	925	11,234	452	5,451
1978	178	5,195	1,347	16,398	1,051	12,735	523	6,193
1979	123	5,526	1,402	18,456	1,080	14,324	504	6,945
1980	48	5,795	1,443	20,638	1,091	15,988	462	7,685
1981	(811)	5,215	905	22,369	541	17,169	(109)	7,883
1982	(311)	5,113	990	24,253	598	18,453	(103)	8,096
1983	225	5,542	1,873	27,096	1,403	20,594	564	8,984
1984	(58)	5,706	1,768	29,948	1,219	22,637	238	9,581
1985	618	4,996 ***	1,679	31,130 ***	1,088	22,975 ***	33	8,413 ***
1986	(2,018)	(5,754)***	(215)	23,228 ***	(838)	14,123 ***	(1,952)	(2,134)***
1987	(1,943)	(14,355)***	(719)	17,009 ***	(1,372)	6,888 ***	(2,538)	(11,185)***

*** Contingent liabilities have been subtracted from these figures.

Commercial Bank Failures: A Historical Perspective

Year	Number of Insured Failures (1)	Number of Insured Banks (2)	Percent of Banks that Failed (3)=(1)/(2)	Assets of Failed Banks ($Thousands) (4)	Assets of all Banks ($Millions) (5)	Percent of Assets Held by Failed Banks (6)=(4)/(5)	Insured Deposits of Insured Banks ($Millions) (7)	Total Deposits of Insured Banks ($Millions) (8)	Insured Deposits of all Failed Banks ($Thousands) (9)
1934	9	14,144	0.06	2,661	46,448	0.01	18,075	39,015	1,968
1935	26	14,126	0.18	17,242	50,927	0.03	20,158	44,147	13,405
1936	69	13,973	0.49	31,941	56,211	0.06	22,330	49,283	27,508
1937	77	13,797	0.56	40,370	54,212	0.07	22,557	47,224	33,677
1938	74	13,661	0.54	69,513	56,800	0.12	23,121	49,779	59,684
1939	60	13,538	0.44	181,514	63,147	0.29	24,650	56,076	157,772
1940	43	13,442	0.32	161,898	70,720	0.23	26,638	63,470	142,430
1941	15	13,430	0.11	34,804	76,827	0.05	28,249	69,421	29,717
1942	20	13,347	0.15	22,254	95,459	0.02	32,837	87,820	19,185
1943	5	13,274	0.04	14,058	112,246	0.01	48,440	104,116	12,525
1944	2	13,268	0.02	2,098	134,613	0.00	56,398	125,752	1,915
1945	1	13,302	0.01	6,392	157,582	0.00	67,021	147,811	5,695
1946	1	13,359	0.01	351	147,365	0.00	73,759	137,029	347
1947	5	13,403	0.04	6,798	152,773	0.00	76,254	141,889	7,040
1948	3	13,419	0.02	10,360	152,163	0.01	75,320	140,683	10,674
1949	5	13,436	0.04	4,886	155,319	0.00	76,589	143,194	6,665
1950	4	13,446	0.03	4,005	166,792	0.00	91,359	153,498	5,513
1951	2	13,455	0.01	3,050	177,449	0.00	96,713	163,192	3,408
1952	3	13,439	0.02	2,388	186,682	0.00	101,841	171,357	3,170
1953	4	13,432	0.03	18,811	191,063	0.01	105,610	175,083	44,711
1954	2	13,323	0.02	1,138	200,588	0.00	110,973	183,309	998
1955	5	13,237	0.04	11,985	209,145	0.01	116,380	190,989	11,953
1956	2	13,218	0.02	12,914	216,145	0.01	121,008	196,507	11,330
1957	2	13,165	0.02	1,253	221,534	0.00	127,055	200,485	11,247
1958	4	13,124	0.03	8,905	237,473	0.00	137,698	215,169	8,240
1959	3	13,114	0.02	2,858	243,423	0.00	142,131	219,012	2,593
1960	1	13,126	0.01	7,506	256,323	0.00	149,684	228,993	6,930
1961	5	13,115	0.04	9,820	277,374	0.00	160,309	247,905	8,936
1962	1	13,124	0.01	0	295,983	0.00	170,210	261,444	3,011
1963	2	13,291	0.02	26,179	311,791	0.01	177,381	274,647	23,444
1964	7	13,493	0.05	25,849	345,130	0.01	191,787	306,230	23,438
1965	5	13,547	0.04	58,750	375,394	0.02	209,690	331,513	43,861
1966	7	13,541	0.05	120,647	402,946	0.03	234,150	352,840	103,523
1967	4	13,517	0.03	11,993	450,713	0.00	261,149	395,795	10,878
1968	3	13,488	0.02	25,154	500,238	0.01	296,701	434,652	22,524
1969	9	13,473	0.07	43,572	524,828	0.01	313,085	436,990	40,134
1970	7	13,511	0.05	62,147	570,352	0.01	349,581	482,514	54,806
1971	6	13,612	0.04	196,520	633,752	0.03	374,568	539,184	132,058
1972	1	13,733	0.01	22,054	731,075	0.00	419,756	616,908	20,480
1973	6	13,976	0.04	1,309,675	825,138	0.16	465,600	681,619	971,296
1974	4	14,230	0.03	3,822,596	904,153	0.42	520,309	746,413	1,575,832
1975	13	14,385	0.09	419,950	938,888	0.04	569,101	780,749	339,574
1976	16	14,411	0.11	1,039,293	1,182,391	0.09	628,263	991,913	864,859
1977	6	14,418	0.04	232,612	1,339,393	0.02	692,533	1,116,618	205,208
1978	7	14,391	0.05	994,035	1,508,331	0.07	760,706	1,233,678	854,154
1979	10	14,364	0.07	132,988	1,692,078	0.01	808,555	1,363,068	110,696
1980	10	14,435	0.07	236,164	1,855,695	0.01	948,717	1,481,163	216,300
1981	10	14,415	0.07	4,859,060	2,029,148	0.24	988,898	1,588,895	3,826,022
1982	42	14,451	0.29	11,632,415	2,193,867	0.53	1,134,221	1,706,138	9,908,379
1983	48	14,469	0.33	7,206,923	2,341,952	0.31	1,268,332	1,842,415	5,441,608
1984	79	14,496	0.54	3,276,411	2,508,407	0.13	1,389,874	1,962,544	2,883,162
1985	120	14,417	0.83	8,741,268	2,730,408	0.32	1,503,393	2,117,776	8,059,441
1986	138 *	14,209	0.97	6,991,600 **	2,941,119	0.24	1,634,302	2,283,462	6,471,100
1987	184 *	13,705	1.34	6,850,700 **	3,000,914	0.23	1,658,802	2,334,900	6,281,500

* Does not include Open Bank Assistance cases.

** Excludes data for banks granted financial assistance under Section 13(c)(1) of the FDIC Act.

Commercial Bank Failures: A Historical Perspective

Year	Net Losses on Failed Banks ($Thousands) (10)	Losses per Dollar Deposit of all Banks (Basis Points) (11)=(10)/(8)	Losses per Dollar Asset of all Banks (Basis Points) (12)=(10)/(5)	Losses per Asset Dollars of Failed Banks (13)=(10)/(4)	Losses per Deposit Dollar of Failures (14)=(10)/(9)	Premium per Dollar of Total Deposits *** (Basis Points) (15)	Total Reserves ($Millions) (16)
1934	207	0.05	0.04	0.0778	0.1052	50.00 ****	292
1935	2,685	0.61	0.53	0.1557	0.2003	8.33	306
1936	2,333	0.47	0.42	0.0730	0.0848	8.33	343
1937	3,672	0.78	0.68	0.0910	0.1090	8.33	383
1938	2,425	0.49	0.43	0.0349	0.0406	8.33	421
1939	7,152	1.28	1.13	0.0394	0.0453	8.33	453
1940	3,796	0.60	0.54	0.0234	0.0267	8.33	496
1941	591	0.09	0.08	0.0170	0.0199	8.33	554
1942	688	0.08	0.07	0.0309	0.0359	8.33	617
1943	123	0.01	0.01	0.0087	0.0098	8.33	703
1944	40	0.00	0.00	0.0191	0.0209	8.33	804
1945	0	0.00	0.00	0.0000	0.0000	8.33	929
1946	0	0.00	0.00	0.0000	0.0000	8.33	1059
1947	59	0.00	0.00	0.0087	0.0084	8.33	1006
1948	641	0.05	0.04	0.0619	0.0601	8.33	1066
1949	369	0.03	0.02	0.0755	0.0554	8.33	1204
1950	1,385	0.09	0.08	0.3458	0.2512	8.33	1244
1951	0	0.00	0.00	0.0000	0.0000	8.33	1282
1952	792	0.05	0.04	0.3317	0.2498	8.33	1364
1953	0	0.00	0.00	0.0000	0.0000	8.33	1451
1954	258	0.01	0.01	0.2267	0.2585	8.33	1543
1955	230	0.01	0.01	0.0192	0.0192	8.33	1640
1956	213	0.01	0.01	0.0165	0.0188	8.33	1742
1957	0	0.00	0.00	0.0000	0.0000	8.33	1851
1958	28	0.00	0.00	0.0031	0.0034	8.33	1965
1959	97	0.00	0.00	0.0339	0.0374	8.33	2090
1960	0	0.00	0.00	0.0000	0.0000	8.33	2222
1961	1,502	0.06	0.05	0.1530	0.1681	8.33	2354
1962	0	0.00	0.00	0.0000	0.0000	8.33	2502
1963	286	0.01	0.01	0.0109	0.0122	8.33	2668
1964	1,540	0.05	0.04	0.0596	0.0657	8.33	2845
1965	663	0.02	0.02	0.0113	0.0151	8.33	3036
1966	245	0.01	0.01	0.0020	0.0024	8.33	3252
1967	1,010	0.03	0.02	0.0042	0.0928	8.33	3486
1968	12	0.00	0.00	0.0005	0.0005	8.33	3749
1969	82	0.00	0.00	0.0019	0.0020	8.33	4051
1970	272	0.01	0.00	0.0044	0.0050	8.33	4380
1971	193	0.00	0.00	0.0010	0.0015	8.33	4740
1972	1,824	0.03	0.02	0.0827	0.0891	8.33	5159
1973	67,032	0.98	0.81	0.0512	0.0690	8.33	5615
1974	635	0.01	0.01	0.0002	0.0004	8.33	6124
1975	16,292	0.21	0.17	0.0388	0.0480	8.33	6716
1976	321	0.00	0.00	0.0003	0.0004	8.33	7269
1977	2,566	0.02	0.02	0.0110	0.0125	8.33	7993
1978	12,044	0.10	0.08	0.0121	0.0141	8.33	8796
1979	10,584	0.08	0.06	0.0796	0.0956	8.33	9793
1980	30,312	0.20	0.16	0.1284	0.1401	8.33	11020
1981	588,902	3.71	2.90	0.1212	0.1539	8.33	12246
1982	1,270,804	7.45	5.79	0.1092	0.1283	8.33	13771
1983	1,521,175	8.26	6.50	0.2111	0.2795	8.33	15429
1984	2,291,521	11.68	9.14	0.6994	0.7948	8.33	16529
1985	925,485	4.37	3.39	0.1059	0.1148	8.33	17957
1986	1,858,854	8.14	6.32	0.2659	0.2873	8.33	18253
1987	2,119,747	9.08	7.06	0.3094	0.3375	8.33	18302

*** Does not include rebates given by the FDIC beginning in 1950.

**** The effective premium was closer to .025

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APPENDIX B

REGULATORY ENHANCEMENTS

Much has been done to ensure that the degree of problems experienced by the thrift industry will not happen again.

I. New Regulations have significantly strengthened our regulatory ability since 1985.

   A. Equity Risk Investment Regulation

      - Rule adopted in 1985 (and further strengthened in 1987); limited investments on the basis of a thrift's tangible capital.

   B. Growth Regulation

      - Rule adopted in 1985 to limit growth to 12-1/2% over any two (2) consecutive quarters. Policy strengthened last year (September) to prohibit asset growth by insolvents and limit growth by troubled institutions to amount equivalent to interest credited. Asset growth for industry, which averaged 19% in 1984 fell to 7.5% in 1987 and was 7.7% per annum through the third quarter of 1988.

   C. Classification of Assets

      - Enabled examiners to classify problem assets using the same procedures as banking agency examiners (12/85 and revised under CEBA).

   D. Uniform Accounting Practices (Adopted as part of CEBA)

      - Requires industry to adopt GAAP accounting by 1/1/93.

   E. Proposed Trading versus Investment Policy Statement

      - Would establish more accurate criteria for reporting value of investment securities and loans. (6/88)

   F. Minimum Capital Regulation

      Rule adopted in 1985 (and strengthened in 1987) phases in 6% capital-to-liabilities requirements. Median GAAP capital-to-total assets ratio, which was 3.5% in 1984, was 5.2% in September 1988.

G. Individual Minimum Capital Requirement

- Authorizes PSA to set Capital Requirements higher than the regulatory minimum on the basis of risk. (12/87

H. Capital Directive

- Provides for issuance of formal directives requiring increased capital. (12/87)

I. **Proposed** Risk Based Capital Regulation

- Establish a more conservative capital requirement requiring an average of 8% capital against risk weighted assets including explicit recognition of interest rate risk. (12/88)

J. **Proposed** Early Intervention Proposal

- Enhances ability of regulatory staff to act promptly when a minimum level of capital (1.5% GAAP) is not maintained. (12/88)

II. Our Regulatory Initiatives are Designed to Ensure the Significant Level of Problems Do Not Recur

A. Quantity of Regulatory staff has doubled.

- 1093 in 1985 to approximately 2100 today.

B. Quality of staff dramatically improved.

- 32% of new examiners have had previous experience.

- 16% of examiners have advanced degrees.

- Directors of Agency Functions and ORA Senior Staff include: the former director and the former associate director of Bank Supervision of the FRB. Former Acting Senior Deputy Comptroller of the Currency for Supervision, Chief and Assistant Chief National Bank Examiner, 3 Deputy Comptrollers, a Big 8 Accounting Partner; and Senior Staff from OMB, the OCC, FRB and FDIC.

C. Training has been enhanced and increased.

- Mandatory core training curriculum for examiners has been implemented.

- Training days per professional has increased by 74% since 1985.

D. National Accreditation Program for Examiners and Supervisory Agents effective 1989.

E. Revised Regulatory Handbooks for examiners and supervisors issued in 1988.

  - Focuses on evaluating risk in Institutions, Holding Companies, and Service Corporations.
  - Uses a top down approach of evaluating management, policies, procedures, and controlled audit.
  - Emphasis on safety and soundness.

F. Thrift Bulletin sets requirements for investing in mortgage derivative.

  - Establish standards for prudently investing in mortgage derivatives and restricts under capitalized and unsophisticated institutions from engaging in certain activities. (9/88)

G. Peer Review Program with quarterly performance reviews established by ORA over District operations.

H. National capital markets examination team being formed to examine capital market activities of large thrift institutions.

I. Comprehensive Interest Rate Risk program being implemented to assist Industry in managing its interest rate risk.

J. National Shared Credit Program being implemented.

K. Uniform classification of high yield bonds program established.

L. Service Corporation Report revised and enhanced.

The CHAIRMAN. Very good. I think also the very substantial presence of Senators indicates the importance with which we view this opportunity to talk with you today.

Let me ask you first, can you give us an up-to-date assessment—I'd like you to do it briefly if you would—as to what we're presently experiencing in terms of loss of deposits at thrifts?

PRESENT ASSESSMENT

Mr. WALL. What we are experiencing as far as the financial services industry in the broadest sense is disintermediation. There is an upward shift that's taken place in the interest rate curve, and it does cause there to be an outflow of deposits from the traditional depository institutions of all kinds.

The week before last we saw the announcement in the paper of money market mutual funds having had their all time ever weekly inflow which took them to their all time ever total investments. So I think you have that piece of normal outflow that occurs at this point in the interest rate cycle.

On the other side of it, when the interest rates tend to come down, the financial institutions are the beneficiaries.

So on the average, they come out about the same. But at this point in the cycle they are the loser.

There is, as well, the business plan assignment from us to acquirers to shrink those institutions that they have acquired. When you're dealing with the level of activity in 1988, that is a significant factor by itself. On average, you could say the institutions' assignments are to shrink by 20 percent. For one of the institutions that is still in our control, Sunbelt in Texas, with several billions of dollars in deposits, their assignment is to shrink by 50 percent. So there's that additional shrinkage that's occurring, and indeed there is shrinkage that's occurring on the private sector side. Yesterday's American Banker newspaper indicated that one of the major national firms, a very profitable firm, by its own choice ran off $3.4 billion of deposits in the month of November and December. Two reasons. One, they got lower cost money by borrowing; and the other, they don't have to pay premiums on that borrowing. So they lowered their business costs.

The CHAIRMAN. Let me ask you this because I don't want to use my whole time period on this. I'd like you to submit for the record for the committee and as soon as possible—I mean today or tomorrow what the outflow levels were for each of the last 6 months. I know we're just in the first day of March, but how current would your data be?

Mr. WALL. We can provide some reasonable estimates for the month of February.

[The information referred to follows:]

Federal Home Loan Bank Board
OFFICE OF THE CHAIRMAN

M. DANNY WALL, Chairman

1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

March 27, 1989

Honorable Donald W. Riegle, Jr.
United States Senate
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Riegle:

Enclosed is the information you requested on historical deposit outflows of deposits at FSLIC-insured thrift institutions. It is worth noting that, although some depositors clearly have made withdrawals during the last six months of 1988 and in January, 1989, total deposits on the books (including interest credited) have grown in all months except November and January.

Based on currently available information, net new deposit withdrawals (without interest credited) are estimated to have been $8-9 billion in February. Available data for early March indicate withdrawals during that period were at a sharply reduced rate.

MARCH LOOKS BETTER!

Sincerely,

M. Danny Wall

Enclosure

FSLIC-INSURED INSTITUTIONS
DEPOSIT ACTIVITY
JUNE, 1988 - JANUARY, 1989
($ Millions)

	Net New Deposits	Interest Credited	Net Deposit Gain
June, 1988	(3,279)	7,621	4,342
July	(357)	2,685	2,329
August	(2,629)	2,753	124
September	(1,878)	7,575	5,697
October	(144)	2,765	2,621
November	(7,049)	2,818	(4,231)
December	(8,340)	8,422	82
January, 1989	(10,744)	2,805	(7,939)

Prepared by OPER/FHLBB.CL

The **Chairman**. What's the lag on the data that you have, 1 week, 2 weeks?

Mr. **Wall**. It's a month in terms of announcing it, but in terms of it being made available to us we are doing it on a fairly broad basis every 10 days.

The **Chairman**. OK. If you would, I'd like you to give it to us on the basis of the monthly figures up through January and for as far into February as you can.

Mr. **Wall**. I can give you that right now in terms of our estimate at this point, if I might, Senator.

There was an outflow from those 220 now publicly identified RAP insolvent institutions, that are in the process of being taken into this conservatorship program, in the month of February of $1.2 billion in deposits. In the month of February overall in the industry, the outflow is projected between $4 and $5 billion totally.

The **Chairman**. That's for the entire month of February as nearly as you can tell?

Mr. **Wall**. For all of the industry.

The **Chairman**. Can you assign a percentage figure to that?

Mr. **Wall**. Half of 1 percent. There's about a trillion dollars in deposits, just under a trillion dollars.

The **Chairman**. So ½ of 1 percent in February. Could you provide the rest of my request I asked for the record?

Let me ask you this, and I won't ask you to elaborate now but I want to come back. I want to tee these issues up so we can then deal with them.

I would like you, if you can, to enumerate, without elaboration, the items in the plan that you think need some adjustment. Can you tell me what those might be categorically? Can you indicate what they are so that the committee can understand where there might be an area that we can spend some time moving into as we go down the table here?

Mr. **Wall**. I think there are three areas as far as the authority of the entity, wherever it's to be, whether it's Treasury or as it is or in some new relationship. There are three areas of concern.

One is in the chartering sense we have to have a significant role and a significant level of activity.

The **Chairman**. All right. Chartering is one. What would be the others.

Mr. **Wall**. In the enforcement, we have to have the final and the appropriate level of authority of enforcement so that we are not just gone around in every case.

The other one would be the rule making, so that we have in a realistic sense the rule making authority which would include of course the ability to set capital standards.

The **Chairman**. Now what would be the next area that you would cite as perhaps needing some adjustment?

Mr. **Wall**. I'd say the next one—more that it needs reinforcement than current adjustment—is the ability to provide for the examination force as not being within the Federal pay restrictions, to make sure that that continues to be the case.

The **Chairman**. Any other parts of the plan that you really have a professional reservation about?

Mr. WALL. I think my colleagues may have their views on various other pieces, but those are mine.

The CHAIRMAN. But as the Chairman, you don't want to draw to our attention any other area of the plan that you're concerned about?

Mr. WALL. Those are the hot buttons as far as I'm concerned.

The CHAIRMAN. Mr. Martin and Mr. White, would you just list categorically any other area that we should get into this morning?

Mr. MARTIN. I think the plan is missing one thing. Basically what we have in the marketplace is a real estate collapse.

The CHAIRMAN. A real estate collapse?

Mr. MARTIN. Right. And if we don't deal with the real estate problem, we're going to have a deeper hole than we have to have—whether it's tax incentives or whatever. We have a real estate collapse, whether it's in Florida, Colorado, Arizona, California, Texas.

The CHAIRMAN. And your point is the plan doesn't deal specifically with that?

Mr. MARTIN. Right. We should have something in there to deal with the real estate collapse.

The CHAIRMAN. Anything else?

Mr. WALL. There was something I knew that I obviously was not recalling and that is the capital requirements and the schedule therefor. I mentioned it in my testimony but I do want to come back and redo that.

The CHAIRMAN. All right. Mr. White, did you want to add anything before I yield to Senator Garn?

Mr. WHITE. Well, I believe that there are three other pieces of fundamental reform that should accompany the working out of the current set of problems: An explicit endorsement of risk-based premiums, an explicit endorsement of early intervention, and an explicit endorsement of a better information system; and by better information I mean market value accounting rather than the historical cost-based accounting that even GAAP, generally accepted accounting principles, involves.

Now, the President's proposal does call for an 18-month study of all three of these principles. I consider them important enough, and I think we know enough, about all three of these, that I had hoped that they would get a stronger endorsement and find their way somehow into the legislation.

The CHAIRMAN. Very good. Let me just make one other comment and then yield to Senator Garn. This is a very complicated story. It goes back for years, and years and we can spend an awful lot of time reconstructing the history. We've already done that I think over several sessions.

I would hope and the Senators will have to make their own judgment on this—that we could concentrate principally today on the plan and how it needs to be adjusted. Try to zero in on those issues because I think time is really of the essence in terms of being able to act on this issue and settle it.

Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

As I'm sure you know, Dan, I have asked virtually every witness a question about the placement of the so-called new Federal Home Loan Bank Board, whether they have three members or one or whatever under Treasury. I personally think this is a mistake. The plan is at fault in trying to do that. I do not agree that the Comptroller of the Currency is a good example and I've cited to each of the witnesses the various studies over the years, over the last 12 to 14 years, that have indicated that the Comptroller of the Currency ought to be taken out from under the umbrella of Treasury and made an independent agency. I've also made the observation that there's no housing component and the Comptroller doesn't have twelve independent banks around the country and that in my view, while I completely agree that the FSLIC insurance function should be separated from the supervision function, I do not feel that we ought to put it under Treasury. I would appreciate the views of you or the other members of the board on this issue.

VIEWS ON FHLBB INDEPENDENCE

Mr. **Wall**. Well, Senator, it clearly is a situation where we as an agency believe that we have done, as I indicated in my testimony and we clearly have indicated more extensively in the written testimony, what needed to be done in a time of distress and stress for the agency as well as the industry.

The assessment has been made that that's not enough, that something more needs to be done, and one way to achieve it is to make an accounting responsibility in a bureaucratic sense. I can see the logic of the Treasury Department link and as that is indeed what the President has put forward we are supportive of that. But we want to be sure that remaining entity that is made to report to the Treasury retains its independence. But clearly we believe that an independent agency is a very operative and very realistic way to move forward.

If in the political sense there's not a will to do so, we recognize the logic as well as the wisdom of it being a part of what a friend of mine has referred to as the "ministry of finance".

Senator **Garn**. Well, I haven't yet been able to get anybody, including the administration, to tell me what is gained. Everybody agrees that we need to make changes in the Federal Home Loan Bank Board and FSLIC and make that separation. How does puting it under the bureaucracy of Treasury, rather than making whatever changes we are going to make to the Board and its structure and supervision, improve the regulatory structure? What is added by putting it under Treasury? No one has been able to answer that question for me.

Mr. **White**. Well, Senator, I have some unorthodox views on both the issues that you raised. I'm on record as favoring the continuing melding of the insurance and regulatory function. I think that that is workable in the sense that the regulator is there to protect the insurance fund. I don't see the conflict that everyone talks about. There were all of the historical problems that Chairman Wall indicated before, but I don't think they were conflict of interest problems.

I'm a lone voice here. I understand I'm a lone voice. I understand that the ship has sailed, but I think it's sailing in the wrong direction.

With respect to the issue of putting the resulting Federal Home Loan Bank System in the Treasury, again I think I'm a lone voice here. From a personal perspective it is wonderful being an independent regulator; we don't have to look up to anyone except to the Congress when it comes to our authority. But, as a philosophical matter, I believe that political responsibility is maximized when a government entity is placed in one of our three branches of government—executive, legislative, judicial.

Senator GARN. Well, an independent agency is answerable to the President and to Congress.

Mr. WHITE. To the Congress, yes. To the President——

Senator GARN. As a general thing, how do we get more accountability putting it with the gnomes of Treasury? I am not concerned about Nick Brady. I am not concerned about who will be a new Secretary of Treasury. I am not concerned about that level. I am concerned about the gnomes of Treasury, the faceless, nameless bureaucrats who, when new Presidents, new Secretaries of Treasury, new chairmen of the Federal Home Loan Bank Board come and go, are still there. They have the closest thing to eternal life you'll ever find on this earth. And that's my question.

What do we gain by placing a regulatory agency under those nameless, faceless bureaucrats who run the place? Secretaries don't. You know that and I know that.

Mr. WHITE. I think you get direct political responsibility with the Secretary——

Senator GARN. Who are not responsible or accountable to a voter anyplace? Nobody knows who they are.

Mr. WHITE. I think the Secretary of the Treasury is ultimately responsible——

Senator GARN. We all have to face reelection. We are accountable for what we do. A President is.

Mr. WHITE. And the Secretary is responsible to him and the individuals within the Treasury would be responsible to the Secretary. There are other places within the executive branch one could place an entity. It needn't only go into Treasury. It could be elsewhere in the executive branch.

Senator GARN. Well, there's no doubt your first statement is correct. You are almost a lone voice on both issues.

My time is up on this round. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. I want to acknowledge Senator Dixon was here and just had to leave to attend another committee. Senators Sarbanes, Kerry, and Shelby have also arrived.

Senator Sarbanes, did you have an initial comment that you wanted to make?

Senator SARBANES. No, Mr. Chairman.

The CHAIRMAN. Senator Kerry?

Senator KERRY. No, Mr. Chairman. I want to thank you for your repeated offers to do so though.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Mr. Chairman, I have an opening statement, I'd like to ask unanimous consent it be made part of the record.

The CHAIRMAN. Without objection it will be.

I also have statements from Senators Sasser and Dixon to be inserted in the record.

OPENING STATEMENT OF SENATOR SHELBY

Senator **Shelby**. Mr. Chairman, I want to join with my colleagues in welcoming today's witness before the committee. Chairman Wall, I would guess that not one of my colleagues on this committee envies your job; you have been Chairman during a very difficult period. You are to be commended for doing a lot with very little and for doing an excellent job in restoring integrity to the thrift regulator.

You affirm in your statement what Chairman Greenspan stated the other day during his testimony, that any estimate of the cost is just that, simply an estimate. Chairman Greenspan continued by saying that trying to get an accurate final figure is an academic exercise, that any proposal will probably need revisiting a few years down the road.

I agree with this opinion. However, I believe that it is essential that we make this proposal as comprehensive and accurate as possible the first time around. As you point out in your statement, Congress had the opportunity in 1987 to do something effective and yet abdicated the responsibility, by passing the buck to a later Congress. This is that later Congress, the cost of the problem has multiplied, and we no longer have the luxury of passing the buck. Therefore, whatever proposal we adopt must work.

Your input is essential. This proposal relies heavily on contributions made by the thrift industry and this raises some concerns over the future of the thrift industry. If we affirm, as this proposal does, that there is a need for a separate thrift industry, it is essential that we provide for its viability. However, the solution affords thrifts very little flexibility and even less capital.

I am concerned over the proposed increased capital requirement that will take effect on June 1, 1991. There is no debate that increased capital levels for thrifts are desirable. Capital is the cushion between the thrift and the insurance fund; it deters management from engaging in risky activities. But we are asking thrifts to almost double their capital level by 1991. At the same time, we are increasing their insurance premiums, sharply reducing their dividends from the district banks, and making them forego the interest earned on this capital. Is this realistic? Can thrifts bear this burden and emerge a healthy industry? Or are we setting up a system that will cripple the healthy segment of the industry and expose the deposit insurance system and the Treasury and thus, the taxpayer, to even greater risk 5, 10, 15 years down the line?

You and your colleagues at the Bank Board have the ability to determine the answer to this question. At this time, no one stands to gain from lowballing the estimate; it's time that we get a handle on the situation and get it behind us. The taxpayers are mad and they're going to get a lot madder if we have to come back to this in just a few years. In your testimony, you mention that independent analysts are not restrained by fact but can engage in speculative analysis. Unfortunately, however, the independent analysts have been closer to right in their estimate of the problem's size. I encourage the Bank Board to perhaps depart from historical data and past experience and judge the numbers with the same pessimism as the outside analysts.

I look forward to the question and answer period.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR SASSER

Senator SASSER. Today we continue our hearings on the savings and loan crisis with testimony from Danny Wall, Chairman of the Federal Home Loan Bank Board.

Mr. Wall has a long history with this committee. In his tenure at the Bank Board, he has devoted enormous energy and industry in attempting to grapple with this financial debacle.

I cannot doubt the sincerity of his efforts.

Yet, Mr. Chairman, I have been disturbed over the past year or so by the message we've received from the Bank Board and from the previous administration.

Mr. Wall told the Budget Committee just last October—just 4 months ago—that he would not obligate the FSLIC further than its ability to pay, and that additional funds were not necessary.

We know now that Mr. Wall was off the mark by billions and billions of dollars last year. And the delay has cost us billions more.

There is a lot of blame to go around in this mess. This committee is not without fault. Yet the regulators are our experts. It's their job to be on top of the situation.

Congress should pay deference to the advice of the regulators. When we can't we're in serious trouble. And that, Mr. Chairman, appears to be what happened here.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman. I am pleased to be here this morning as the Senate Banking Committee continues its hearings on the thrift industry crisis. I welcome back a former Banking Committee staff director, now Chairman of the Federal Home Loan Bank Board, Danny Wall.

Last month on the Senate floor and last week before this committee, I outlined a series of basic principles that I believe any legislative solution must meet. One of those basic principles is that the solution of the thrift industry problems must be cost-effective. Cost-effectiveness should include having enough resources to refinance and reduce the costs of the transactions FSLIC has already completed.

FSLIC completed over $38 billion of these deals by the end of this past December. In my view, these were not good deals. They were extraordinarily expensive. Taxpayers are paying too high a bill.

As I understand it, much of the financing that FSLIC has provided to acquirers of failed thrifts in these deals is callable at FSLIC's option. I would like to know from Mr. Wall how much cash would be needed to refinance these transactions in the most cost-effective manner? How much interest expense—and principal, if any—might by saved? Furthermore, how much could tax losses to the Treasury be reduced if these deals were refinanced?

We are asking a tremendous amount from taxpayers to clean up the thrift crisis. And it is extremely important to our whole economy that confidence in the deposit insurance system be maintained. But we should not ask taxpayers to pay one red cent that is not necessary. A cost-effective solution must be large enough to cut the financing costs and the tax costs of the FSLIC deals by refinancing them.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Wirth.

Senator WIRTH. Thank you very much, Mr. Chairman.

Mr. Wall, again welcome. You and I have talked in the past about the process that the Bank Board used in soliciting bids and I'd just like to clarify, if I might, a couple of points for the record.

CONTACTING HEALTHY THRIFTS TO POSSIBLY TAKE OVER INSOLVENT THRIFTS

Can you tell me if it is the Bank Board's policy to contact healthy thrifts in an area where there were thrifts that were having real problems to see if the healthy thrifts were interested in taking over the insolvent institutions?

Mr. WALL. Yes.

Senator WIRTH. And did all of those healthy thrifts have to be on the qualified bidders list?

Mr. WALL. Not necessarily, but we also had a criterion as to what their size was versus the size of the target.

Senator WIRTH. Was that true for both unassisted and assisted acquisitions?

Mr. WALL. In the case of unassisted, that would be exclusively who we would have gone to, at least at the first stage, and unassisted as well.

Senator WIRTH. But it was your policy to contact healthy thrifts for assisted acquisitions as well?

Mr. WALL. Yes.

Senator WIRTH. Well, let me submit if I might, Mr. Chairman, for the record my letter to Mr. Wall of December 28 and his response to me of January 6, 1989, and Bank Western's response to that letter of February 27.

The CHAIRMAN. No objection.

[The following material was subsequently submitted for the record:]

TIMOTHY WIRTH
COLORADO

United States Senate
WASHINGTON, DC 20510

December 28, 1988

Mr. M. Danny Wall
Chairman
Federal Home Loan Bank Board
1700 G Street NW
Washington, D.C. 20552

Dear Chairman Wall:

I have longtime and growing concerns over the plans of the Federal Home Loan Bank Board (FHLBB) and the Federal Savings and Loan Insurance Corporation (FSLIC) to sell insolvent thrift institutions to some of this nation's largest corporations and multi-billion dollar syndicates. As you know, several of my concerns have been reflected in Senate hearings, correspondence and press accounts.

First, I am alarmed by the plans to sell off failed thrifts across the nation -- particularly in Colorado, Oklahoma and Texas -- that result in concentrating the ownership of savings and loan institutions in so few hands. For example, First Nationwide Bank, a subsidiary of the Ford Motor Company, has publicly boasted that the acquisitions of thrifts from FSLIC will enable Ford to become a $42-billion to $50-billion financial intermediary that would dominate the savings and loan industry.

It is unclear to me that the Congress has decided that the public is best served by such a concentration of economic power in a single corporate institution. Yet the localized character of thrift organizations -- which permitted this business through its mortgage services to play such an important role in housing America for 155 years -- seems to be of little importance to the FHLBB as it seeks a resolution to this crisis. Further, for the last 50 years, the Congress generally has adhered to a policy that rejected joining financial institutions with large commercial ventures. The separation of responsibilities best served the goal of safe and sound financial institutions. This longstanding policy is starkly at variance with the proposed Ford deal.

In addition, the Congress and the public appear not to be fully aware of and not to condone the significant tax losses that would result from this and similar transactions. I understand that an investment of approximately $400 million by Ford's financial subsidiary, First Nationwide, would yield nearly $4 billion of tax benefits. These in turn would be transferred up to the parent company, offsetting taxes owed by the Ford Motor Company. As a result, the taxpayer would be penalized through a significant loss to the federal treasury (at a time when the federal deficit already looms dangerously), while the Ford Motor Company would benefit from a tax windfall. While we do need to attract additional outside capital to minimize the impact of the savings and loan failures on the taxpayers, I find it difficult to believe that, on balance, the public would be well served by this transaction.

Finally, in exchanges at Senate hearings, and in a formal request for a study by the General Accounting Office, I have asked about the criteria which the FHLBB has established for awarding these generous settlements. Now it has come to my attention that in your agency's efforts to sell both Silverado and First Columbia savings and loan associations of Colorado, the FHLBB failed to invite other solvent and well-managed local savings and loan associations to bid. Is it the Board's policy to shut out those who have successfully tended their businesses and to favor large national entities with little relevant experience and no local or regional involvement -- at taxpayer expense?

Because of your rush to conclude deals before December 31, there is an urgency to my letter. I would appreciate a telephone call or immediate written response which will help allay my concerns about the plans of the FHLBB and the FSLIC in dealing with the thrift crisis. I have serious questions about the impact your plans will have on the federal budget, the competitive balance of the remaining thrift industry and the concentration of power within our financial systems.

Sincerely yours,

Timothy E. Wirth

Timothy E. Wirth

Federal Home Loan Bank Board
OFFICE OF THE CHAIRMAN

M. DANNY WALL, Chairman

1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

January 6, 1989

RECEIVED JAN - 9 [illegible]

The Honorable Senator Timothy E. Wirth
Russell Senate Office Building
Room 380
Washington, D.C. 20510

Dear Senator Wirth:

As a follow-up to our telephone conversation last week I am forwarding to you the following items:

a. A summary of the marketing efforts for both Silverado and Columbia, including efforts to determine the interests of Bank Western in acquiring either of the two institutions,

b. Two memoranda from Board Member White which discuss the implications to case resolution decisions when an overall government revenue perspective is used,

c. An estimate of the forgone tax revenues expected in the First Nationwide transactions, and

d. An estimate of the cost savings to the FSLIC for having completed the transaction in 1988 as opposed to 1989.

I hope these answers are responsive to your questions. If I can be of any further assistance to you, please call.

Sincerely,

M. Danny Wall

M. Danny Wall

Attachments
MDW/rml

III. SOLUTION EFFORTS: Columbia

Pursuant to a conditional concord in the 1988 Capital Forbearance Agreement between FHLB of Topeka and Columbia, Columbia was required to attempt find a purchaser for its stock. Columbia filed a report with the District Bank outlining contacts with investment banking firms and private investors. No interest was expressed by contacted parties. In November of 1988, the FHLB of Topeka attempted to market the institution to Bank Western Savings and Loan Association, Denver, Colorado. In a telephone conversation, Bank Western's president indicated that Bank Western was not interested in acquiring Columbia on an unassisted basis. It was also determined by the FSLIC that Bank Western did not meet the required asset size to acquire both Columbia and Mile High in an assisted transaction.

On November 8, 1988, the Mergers and Acquisitions Division of the FSLIC mailed a letter responding to interest expressed in acquiring Columbia and Silverado (Mile High) by: 1) Hyperion Partners L.P. via a letter dated 10/24/88; and 2) First Nationwide via phone conversation 10/5 or 10/6/88. The letter contained a proposed deal structure for the acquisition of the two forementioned Colorado institutions. The FSLIC required that responses from potential acquirers be received by November 15, 1988; both parties complied. The initial proposals received from Hyperion Partners and First Nationwide appeared too costly. Although, First Nationwide's proposal was costly, there was a potential lower cost of solution due to the probable tax benefits available. On November 23, 1988, another proposal relating to the acquisition was received from the Colorado Investor Group. This proposal was deemed too costly and the FSLIC mailed a letter to the Colorado Investor Group dated November 28, 1988, rejecting their proposal, explaining that a less costly solution was believed to be available . The Colorado Group submitted a revised proposal for the Colorado shops on December 1, 1988. First Nationwide submitted a revised proposal for the acquisition of Pathway Financial in order to meet a December 2, 1988, marketing deadline.

In an attempt to reduce the cost of their respective proposals, all three interested parties submitted final revised bids: Hyperion Partners on December 6, 1988, First Nationwide on December 13, 1988, and Colorado Group on December 20, 1988.

Name	City, State	Description
Colorado Investor Group	Houston, TX	Private Investors
First Nationwide Bank	San Francisco, CA	Thrift
Hyperion Partners L.P.	New York, NY	Private Investors

IV. MARKETING EFFORTS: Silverado

FHLBank of Topeka Supervisory Staff contacted the only qualified in-state institution, Bank Western, during the first week of September, 1988 regarding any interest in acquiring Silverado. Bank Western expressed no interest in acquiring Silverado. No further attempts to market Silverado have been made. Silverado's large contingent liabilities and small core deposit base have made it very unattractive to potential acquirors.

On November 8, 1988 FSLIC-MAD sent a letter in response to interest expressed in acquiring Columbia Savings, A FS&LA (Columbia) and Silverado by Hyperion Partners L. P. (in a letter dated October 24) and First Nationwide (in a telephone conversation on November 5 or 6). The letter contained a proposed deal structure for the acquisition of the two Colorado institutions. Responses were requested by November 15, 1988. Both parties responded by November 15th. The Hyperion Partners L. P. (Hyperion) proposal was too costly due to requested mark-to-market adjustments. The First Nationwide proposal was costly as well, but due to the tax benefits available, a less costly solution seemed probable. Another proposal relating to the acquisitions was received on November 23 from the Colorado Investor Group (Colorado Group). This proposal was deemed too costly and the FSLIC mailed a letter to the Colorado Group dated November 28, 1988, rejecting their proposal and explaining that a less costly solution was believed to be available. The Colorado Group submitted a revised proposal for the Colorado institutions on December 1, and First Nationwide submitted a revised proposal for Pathway (to meet a December 2 marketing deadline). All three interested parties submitted final revised proposals to try to reduce their costs (Hyperion on December 6, First Nationwide on December 13, and the Colorado Group on December 20).

Name	City, State	Description
Colorado Investor Group	Houston, TX	Private Investors
First Nationwide Bank	San Francisco, CA	Thrift
Hyperion Partners L. P.	New York, NY	Private Investors

Federal Home Loan Bank Board

LAWRENCE J. WHITE
BOARD MEMBER

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

TO : M. Danny Wall
Roger F. Martin
James E. Boland
Stuart D. Root

FROM : Lawrence J. White

SUBJECT: IRS Tax Losses and FSLIC Savings

DATE : December 20, 1988

I am concerned about the Board's decisions in choosing between assisted acquisitions and liquidations when tax benefits are heavily involved. I believe that an overall government revenue perspective needs to be considered. Specifically, in light of the Board's reluctance to proceed with the Beverly Hills transaction on the terms that were presented last Thursday, I would suggest the following framework and criteria for considering the extent of IRS tax losses in our decisions concerning assisted acquisitions:

The aggregate tax revenue collections (calculated on a present-value discounted basis) that are foregone by the IRS as a consequence of an assisted transaction (as compared with liquidation) should be a statistic that is presented to the Board in any cases where these foregone tax collections are likely to be significant. These foregone tax collections occur because an acquirer can shelter the losses associated with the acquisition of a thrift against future income or income earned elsewhere, thus reducing the tax payments he would otherwise be making to the IRS. These losses encompass the past net operating losses (NOLs) that can be carried forward, the embedded or built-in losses, and the expected future "losses" that arise because an acquirer does not have to report the receipt of yield maintenance payments and interest on FSLIC notes as taxable income. The foregone tax collections are (roughly) equal to these losses multiplied by the acquirer's marginal tax rate. In most cases, the foregone tax collections are about a third of the losses.

These foregone tax collections should be compared to the FSLIC's aggregate savings (present discounted value), inclusive of any tax benefits directly received by the FSLIC, achieved by resolving the case through the assisted acquisition rather than liquidation. This comparison would allow us to determine whether the assisted acquisition or the liquidation is the lowest cost alternative from the perspective of the overall U.S. Government. (This comparison implicitly assumes that some form of revenue allocation by the Congress to the FSLIC will be made in the future, so that both the "front door" revenue allocation and the "back door" IRS foregone tax revenues should be weighed in any case resolution decision.) An equivalent result would be yielded by adding together the IRS's foregone tax collections and the FSLIC's net cost (inclusive of any tax benefits received) of the assisted acquisition, and then comparing this sum (the government's total cost) with the FSLIC's cost of liquidation.

Note that the cost savings to the FSLIC need not take the form explicitly of tax benefits directly allocated to the FSLIC as part of the transaction. The important result is that the aggregate savings occur in some form, regardless of whether it comes from the tax benefits or from the other terms of the transaction, such as the premium paid for the going-concern value of the thrift, a lower interest rate on the FSLIC notes, a lower rate on the yield maintenance on covered assets, greater loss sharing on covered assets, etc.

If, by resolving a case through an assisted acquisition rather than through a liquidation, the FSLIC's savings exceed the IRS's foregone tax collections, then that assisted acquisition will mean a net reduction in the use of government cash resources. On these grounds, then, that assisted acquisition should be favored over liquidation.

At the other extreme, if the FSLIC's savings from the assisted acquisition fall far short of the IRS's foregone tax revenues, then liquidation would be the least cost solution from the overall government perspective.

An argument can be made, however, that approval of an assisted acquisition that yields only a modest shortfall of FSLIC's savings as compared with IRS's foregone tax collections could nevertheless be justified. The justification would be that the AED calculation of the FSLIC's cost savings underestimate the true savings, because liquidation could probably occur only sometime in the future. In the interim, operating losses would continue, part of which would be a net addition to the FSLIC's eventual costs of liquidation; also, if the insolvent thrift is a high rate payer, the interest costs of other thrifts that are competitive with it would continue to be bid up. Another argument that points in the same direction is that the IRS might lose some of the tax revenues from the potential acquirer anyway, if he found some other tax sheltered investment instead of acquiring the insolvent thrift.

My "horseback" judgment is that a justifiable "modest" shortfall would be no more than one-third; i.e., the FSLIC's cost savings should be equal to at least 67% of the IRS's foregone tax revenues. I offer this not as a "scientific" judgment but as my feel for what seems appropriate.

I realize that the Congress has approved these tax provisions so as to benefit the FSLIC. And they were worth fighting to preserve, because they do allow us to stretch our limited resources farther. But, with the prospect of a Congressional allocation of funds looming more likely, we need to place limits on the effective loss of government revenues.

A numerical example may help clarify some of these concepts: Suppose the FSLIC faces the choice of an assisted acquisition that would cost $900 million (including any tax benefits that are allocated to the FSLIC), versus a liquidation cost for the same institution of $1 billion. Thus the FSLIC's cost savings would be $100 million. If the IRS's foregone tax collections were only $70 million, the government (net) saves money. If the foregone tax collections were $250 million, I believe that the net loss of revenues would be too large, and I would generally not be in favor of proceeding with that acquisition.

Following these principles, I am reluctant to proceed with the LAMB package on its current terms, as presented by Leo Blaber. (See attached.) It appears that the IRS will lose $190 million in foregone tax collections, while the FSLIC's aggregate savings would be only $85 million. I believe that the shortfall is too great to justify going forward.

Attachment

Federal
Home Loan Bank
Board
111 East Wacker Drive, Chicago, Illinois 60601-4360

Seventh District Office

MEMORANDUM

Date: December 16, 1988

To: M. Danny Wall, Chairman
Roger F. Martin, Board Member
Lawrence J. White, Board Member

From: Leo B. Blaber, Jr.

RE: The LAMB Project

This morning Board Member White requested that I furnish to the Bank Board an analysis of the distribution of tax benefits on this transaction. The attached documentation is a rough approximation, but it is the best we can do granted the time constraints under which we are operating.

In this transaction the NOL's are divided 75% to the acquirer and 25% to FSLIC; the capital losses are 50% - 50%; and the tax benefits from the interest income are divided 70% - 30%. The analysis assumes that the covered assets are disposed of at the rate utilized in the FSLIC analysis of these transactions and utilizes the acquirer's schedule of NOL utilization which is over a four year period. The $12.3 million figure inserted at the bottom of the present value FSLIC column is an upfront contribution representing prepaid tax benefits to us.

Using all of the above assumptions and assuming that all tax benefits can be maximized, it appears that the approximate benefit of the transaction to the acquirer would be $128 million, and the approximate benefit to FSLIC would be approximately $61 million. The cost of liquidation of the four organizations representing this package approximates $464 million. A final resolution cost is being prepared, so at the moment it is impossible to determine the additional benefits to FSLIC over and above the impact of the taxes.

Our first cut prior to negotiating the deduction of $12.3 million plus another $900,000 which is not tax related from the FSLIC Note suggested a relationship of cost of resolution

Applications (312) 565-5700 / Examinations (312) 353-5777 / Supervision (312) 565-5744
Mailing address: Post Office Box 7809, Chicago, Illinois 60680-7809

to cost of liquidation of just under 95%. Thus, without tax affecting the transaction, the solution would have cost around $440 million or $24 million less than the cost of liquidation. If we add $24 million to the $61 million present value of the tax benefits, the return to FSLIC is $85 million compared to foregone tax revenue of $125 million, a ratio of approximately 1.5 to 1.

128
+61
189

No; its $19

2.2

I realize that the Board is wrestling with a ratehr complex public policy issue in these case resolutions. My exposure to these four institutions and their balance sheet composition over the past several months suggests that there is no franchise value to speak of in these companies. Their losses mount month by month, so in my view it would not take long to absorb the present value difference of $43 million between this resolution and the $128 million alternative. Thus I would continue to recommend this solution, particularly in view of the fact that we will receive a cash capital infusion equal to 3 1/2% of the liabilities of the disappearing institutions, and have upside potential on the warrants.

$105

$190

Until I am advised otherwise, I will continue to move forward towards a formal presentation of this case to the Bank Board. I believe it is highly likely that we will be able to resolve this package in 1988. I am meeting with the staff that is involved as well as with the proposed acquirer on Monday morning, December 19, at 9:00 a.m. I would be available to meet with you individually or collectively at almost any time on Monday. I will be staying at the Vista International Hotel and will arrive there Sunday evening. If you should wish to contact me over the weekend, my home telephone number is 312-848-8554.

LBB:awb
attachments (2)

CC: S. Root
T. Lykos
E. Bonhomme

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

Federal Home Loan Bank Board

LAWRENCE J. WHITE
BOARD MEMBER

TO : M. Danny Wall
Roger F. Martin
James E. Boland
Stuart D. Root

FROM : Lawrence J. White

SUBJECT: The LAMB Package: An Update

DATE : December 29, 1988

Last week I indicated that I believed that the FSLIC's net savings from the LAMB transaction (as compared to the cost of liquidation) were too small in comparison with the IRS's foregone tax revenues. Hence, at that time, I was reluctant to proceed with the LAMB transaction.

Two important changes have occurred since then. First, and most importantly, the transaction has been renegotiated, so that the FSLIC will receive an additional $25 million (discounted present value) in the transaction. Second, it turns out that Leo Blaber had made some errors in his calculations of the FSLIC's cost savings and in the IRS's foregone tax revenues.

With these changes, the FSLIC's cost savings now appear to be around $120 million, while the IRS's foregone tax revenues appear to be around $145 million. The ratio of the two (83%) is well above the minimum level (67%) that I believe is necessary to justify a transaction. (As I stated earlier, a modest shortfall from 100% can be justified, since there are benefits to the FSLIC from concluding a transaction that are not included in the ratio: the stemming of future losses of the insolvent thrift and a likely decrease in interest rates paid by neighboring thrifts. Also, if the acquirer could otherwise have found another way to shelter his income or if he would have been subject to the alternative minimum tax, the calculation of the IRS's foregone tax revenues due to this transaction may be overstated.)

As a consequence, I am now prepared to endorse the LAMB transaction.

TO: M. Danny Wall
Chairman, FHLBB

DATE: January 4, 1989

FROM: Carlos M. Fiol
Director, AED

SUBJECT: Estimating the Total Foregone Tax Collections in the First Nationwide Transaction

Per your request, the following is an estimate of the "aggregate" cost to the Federal Government of the First Nationwide proposal for: Pathway, Cardinal, Columbia & Silverado(Mile High). The aggregate cost is defined as the sum of the present value cost to the FSLIC of the assistance agreement and the present value cost of the estimated tax collections foregone by the IRS as a result of tax-free assistance provided in the FSLIC tranaction. The foregone IRS Tax collections are defined as those amounts that would have been received by the IRS had there been no tax-free assistance available.

In the following presentation First Nationwide offered to tax-effect the Capital Loss coverage: Losses*(1-.34) and the Yield Subsidy: YS*(1-(.34*.25)). The actual assistance payments for Capital Losses & Yield Subsidy have been "grossed-up" and the tax rate applied to determine what the IRS has foregone.

Foregone tax collections in actuality could also include NOL's utilized. The foregone tax collections due to the use of NOL's is an extremely difficult calculation to make due to the fact that the actual utilization of NOL's will be dependent upon: the ultimate structure(as it evolves at First Nationwide), the timing of the anticipated reorganization, any NOL's available to First Nationwide from prior acquisitions, and First Nationwide's profitability.

However, indications are that the NOL's for 1988 will probably not be available for First Nationwide. [This is reinforced by the fact that First Nationwide was willing to give the FSLIC 80% of the tax benefits derived from NOL's.]

		(Millions $)
Present Value Cost of Foregone IRS Tax Collections(see attached schedule) (exclusive of NOL's)		$ 651
Present Value Cost of First Nationwide Proposal		1,669
Total Aggregate Cost(exclusive of NOL's)		2,320
Present Value Cost of Liquidation		2,430
Cost Savings:		
Cost of Liquidation	2,430	
Cost of Solution(FN Proposal)	1,669	761
67% of Foregone IRS Tax Collections		436
Excess of FSLIC Savings over 67% of foregone collections		325

First Nationwide Transaction
Schedule of Foregone Tax Collections

(Millions $)

FSLIC Notes	$ FACE	$ Interest	PV Interest	Tax Rate	PV of Foregone Tax Collections
	$ 533.290	$ 391.582	$ 250.415	.34	$ 85.141
	489.257	432.638	276.750	.34	94.095
Capital Loss Coverage	$ PMT	PV of PMT	PV/ .66		
Pathway	$ 25.946	$ 19.984	$ 30.278	.34	$ 10.295
Cardinal	87.524	67.412	102.129	.34	34.724
Columbia & Silverado	536.224	464.327	703.526	.34	239.199
Yield Subsidy	$ PMT	PV of PMT	PV/ .915		
Pathway	$ 41.020	$ 33.159	$ 36.239	.34	$ 12.321
Cardinal	111.021	90.238	98.621	.34	33.531
Columbia & Silverado	435.780	380.182	415.499	.34	141.270
TOTAL			$ 1,913.457	.34	$ 650.576

TO:	M. Danny Wall Chairman, FHLBB	DATE:	January 5, 1988
FROM:	Carlos M. Fiol Director, AED	SUBJECT:	First Nationwide Transaction Comparative Cost Savings of 1988 vs 1989 Resolution

As you requested, we have calculated the Cost Savings to the FSLIC of completing the First Nationwide Transaction(Silverado, Columbia, Pathway, Cardinal) in 1988 versus completing the transaction in 1989. Please understand that this calculation is a rough approximation. The analysis shows that by waiting until after the Tax Law change effective January 1, 1989, there would be $ 268 million in additional taxes paid by First Nationwide.

Assuming that First Nationwide would have expected the FSLIC to adjust their proposal accordingly, the cost of a transaction in 1989 would cost an extra $268 million to the FSLIC (Present Value $ 180 million).

In this analysis we have assumed the following:

Discount Rate: FICO Bond Rate 9.86%

Tax Rate: 34%

Taxes Paid by First Nationwide had the tranaction occurred in 1988: $ -0- (ALT MIN TAX not calculated)

FSLIC Note is included in the Year 1 calculation of the 50% offset.

NOL Sharing: assumed 100% to First Nationwide had the transaction be done in 1989(in lieu of 20% for First Nationwide under the actual agreement).

Existing NOLs: assumed to be $ 744 million, based ORA statistical data, since the amount of actual NOLs is not known.

The 1989 transaction would have taken place on January 1st, so that there would not have been any additional operating losses to increase negative net worth.

CENTEX

Calculation of Tax Benefits

NOL'S APPLIED.	1988	Centex	P.V. Centex	FSLIC	P.V. FSLIC
1989	$57M. x 34% = 19.38	14.54	13.73 13.23	3.35	3.0
1990	57M x 34% = 19.38	14.54	12.05	3.35	2.7
1991	57M x 34% = 19.38	14.54	10.97	3.35	2.5
[illegible]	171 x [illegible] = [illegible]	43.62	~~36.25~~ 44.48	10.05	8.3
Deduction from NWD					12.3
					20.6

CAPITAL LOSSES		Centex	P.V. Centex	FSLIC	P.V. FSLIC
1989	102 x 34 = 34	17	15	17	15
1990	7,886 x 34 = 2,681	1,340	1,110	1,340	1,11
1991	10,788 x 34 = 3,668	1,834	1,383	1,834	1,38
1992	16,873 x 34 = 5,737	2,868	1,969	2,868	1,9
1993	18,900 x 34 = 6,426	3,213	2,007	3,213	200
1994	18,880 x 34 = 6,419	3,210	1,826	3,210	18
1995	18,908 x 34 = 6,429	3,215	1,664	3,215	1,6
1996	14,117 x 34 = 4,800	2400	1,131	2400	11
1997	033 x 34 = 11	5	2	5	
1998	008 x 34 = 3	1	–	1	–
	106,495	18,103	11,107	18,103	11,1

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INTEREST INCOME - 70-30%

				CENTER	P.V CENTER	FSLIC	P.V. FSLIC
1989	49,903	x 34 =	16,967	11,877	10,811	5,090	
1990	52,902		17,987	12,591	10,432	5,396	
1991	50,693		17,236	12,064	9,099	5,172	
1992	49,155		16,713	11,698	8,031	5,015	
1993	46,442		15,790	11,053	6,907	4,737	
1994	44,353		15,080	10,536	6,004	4,524	
1995	42,076		14,306	10,014	5,185	4,292	
1996	39,883		13,560	9,492	4,473	4,068	
1997	29,165		9,916	6,941	2,978	2,975	
1997	38,884		13,221	9,254	3,613	3,967	
Tot	$443,456				67,533		28.9

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BANK WESTERN
a Federal Savings Bank

700 Seventeenth Street, Denver, Colorado 80202-3387 (303) 623-6100

Junius F. Baxter
Chairman of the Board

February 27, 1989

The Honorable Timothy E. Wirth
United States Senator
Russell Senate Office Building
Room 380
Washington, D.C. 20510

Attention: Michael Perko

Dear Senator Wirth:

You have inquired about efforts of the Federal Home Loan Bank Board or the FSLIC in 1988 to market either Silverado or Columbia Savings of Denver, Colorado to Bank Western.

As you know, for a period of time after becoming insolvent, Columbia Savings operated under a forebearance agreement between the institution and its regulators. Sometime during the last half of 1988, the forebearance agreement was recinded and Columbia Savings announced it was looking for a buyer on an unassisted basis. While this was known to Bank Western, on unassisted terms and with Columbia's negative net worth, we were not interested in acquiring the association. Apparently no other entity was either.

Also, during the last half of 1988, Bank Western became aware of Silverado's troubles. To the best of our knowledge, however, prior to its seizure by the FSLIC late in the year, Silverado was not marketed to us or to other prospective buyers on an assisted basis. Without FSLIC assistance an acquisition made no sense.

In November 1988, it was announced by the regulators that Columbia Savings and Silverado were being packaged and offered together as a unit and as such on an assisted basis to qualified buyers. Bank Western at no time was invited to bid by the FSLIC or the Federal Home Loan Bank Board on Silverado or Columbia Savings individually or for that matter combined on the basis of an assisted transaction.

The Honorable Timothy E. Wirth
February 27, 1989
Page 2

While Bank Western with FSLIC assistance would have considered an opportunity to formally bid on either one of the associations individually, we were not invited to do so. On a combined basis we would have deemed an acquisition of between $5 and 6 billion in size, even with assistance, beyond our means.

Sincerely yours,

J. F. Baxter

J. F. Baxter
Chairman of the Board

JFB:sw

Senator WIRTH. Thank you very much, Mr. Chairman.

I had asked Mr. Wall why it was that Bank Western, which is a very large and healthy thrift in Colorado, had not been contacted. Mr. Wall told me in his letter of January 6 that they had been contacted both for the acquisition of Silverado and the acquisition of Columbia, and that came as a surprise to me because Bank Western had said just the opposite.

So I sent the information to Bank Western and got back from them a response in the negative that they never had been contacted.

Now I ask this question, Mr. Chairman—I know there were a lot of things going on very rapidly at the end of the year, but I think we have a responsibility to know what did happen. There have been a lot of allegations made about friendly acquisitions, about favoritism and so on, and I think that those ought to be dispelled if there weren't any such activities and this is a good example. Why did the Bank Board go out of State on this situation, having told us that they talked to Bank Western and Bank Western says they didn't.

So I will submit this correspondence for the record and, Mr. Wall, maybe for the record we could get a response back.

Mr. WALL. Yes, indeed. I would make a point if I might. There are three criteria that are used in terms of whether or not we contact institutions in terms of the acquisition of a failed institution. One is that we have a criterion that the possible acquirer has to be twice as large as the target; two, they have to have sufficient capital, real capital; and three, they have to have recognized and competent management. So these are the three criteria.

Senator WIRTH. I'll just leave you with this and you can take a look at that.

Let me ask you a second question. Maybe this goes to Mr. White. I think you testified a couple weeks ago in front of the House committee that the tax benefits of the negotiated agreements were viewed by FSLIC as another asset in the thrift package, is that right?

Mr. WHITE. That's correct.

Senator WIRTH. How did the FSLIC determine the value of the tax benefits to potential acquirers?

Mr. WHITE. Well, it has to be an estimate of what the tax paying position of the acquirer is going to be.

Senator WIRTH. Did you go through the tax returns of the potential acquirer?

Mr. WHITE. Not having done the actual negotiation myself——

Senator WIRTH. At FSLIC do you have tax specialists or tax attorneys who went through the——

Mr. WHITE. Yes, and we certainly have made estimates.

Senator WIRTH. And did they make those estimates by going through their tax returns or by talking to them and asking them how much they made?

Mr. WHITE. I assume that's the kind of information that our negotiators were using. If we're dealing with a troubled corporation, we know what their tax returns are. If we're dealing with a private investor, we would be getting financial statements from that private investor. That's the kind of information we would get.

Senator WIRTH. Again going back to the points I made with the Bank Board last fall, there have been a number of allegations made that the agreements or the deals made by the Bank Board favored one group over another. The answer coming back is, oh, no, this was all done with very fair criteria. Some of those fair criteria certainly had to include an examination of what the tax benefits were going to be. In order to understand those tax benefits you certainly would have had to have looked, or have the capability of looking, at what the potential acquirers tax situation would be.

Mr. WHITE. That's correct.

Senator WIRTH. Well, let me submit that question for the record as well and you can answer that in a more detailed fashion. I would just like to get that allegation off the table as well if we can.

Third, last December the Bank Board announced that it retained four outside experts to evaluate the structure of the Board's Southwest plan and submit recommendations to the Board by mid-January.

Mr. Chairman, I'd like to include in the record the press release put out by the Bank Board on December 15 announcing this particular group.

[The following press release is submitted for the record:]

**Federal
Home Loan
Bank
Board**

NEWS

1700 G Street, N.W., Washington, D.C. 20552 Telephone (202) 377-6677

FOR RELEASE at 3 p.m. EST
Thursday, December 15, 1988
FHLBB 88-264

For further information:
Contact: Marc Adams
(202)377-7362

BANK BOARD NAMES EXPERTS
TO ADVISE ON SOUTHWEST PLAN

WASHINGTON, D.C., Dec. 9, 1988 -- The Federal Home Loan Bank Board has retained four outside experts to provide advice on the terms of financial assistance agreements negotiated under the Bank Board's Southwest Plan.

The consultants will advise the Federal Savings and Loan Insurance Corporation (FSLIC), which is financially responsible for many of the assets that are held by thrifts acquired under the plan. They will provide independent expertise and analysis, thus enhancing oversight of Southwest Plan transactions.

The assistance agreements affect "many billions of dollars of FSLIC-guaranteed assets" in Texas, said Bank Board Chairman M. Danny Wall, and "we strengthen our position by acquiring the guidance of four outstanding industry and real estate professionals to advise FSLIC on the most efficient use of assistance funds with respect to consolidations."

The consultants are Claude M. Ballard, a general partner of Goldman, Sachs & Co.; James C. Schmidt, vice chairman and managing officer of Great American First Savings Bank, a $15 billion association headquartered in San Diego, Calif.; Thomas H. Borehoff, chairman, president, and chief executive officer of First

-more-

Board - 2

Federal Savings and Loan Association of Rochester, N. Y., a $5.4 billion savings and loan; and Jack Benton, president of Benton International, a financial services consulting firm based in Los Angeles, Cal.

Ballard is a former senior vice president in the real estate investment department of Prudential Insurance Company and a former president of the Urban Land Research Foundation and the Urban Land Institute. Schmidt is a director of the Federal Home Loan Bank of San Francisco and is a member of the Federal Savings and Loan Advisory Council (FSLAC). Borshoff has been a member of the FSLIC Industry Advisory Committee. Benton served on the National Commission on Electronic Funds Transfer under presidents Gerald Ford and Jimmy Carter.

The consultants will evaluate the structure of the Southwest Plan and submit recommendations to Chairman Wall by mid-January. They will receive no salary, but will be reimbursed for travel and administrative expenses.

The Southwest Plan was announced by the Bank Board in February 1988 to deal with more than 100 insolvent institutions in Texas. The strategy is to reduce the number of troubled Texas thrifts through consolidation, thereby lowering operating expenses and the cost of funds, and to attract outside capital and sound management to the Texas thrift industry. As of Dec. 2, 1988, FSLIC had resolved 54 insolvent thrifts under the Southwest Plan, mostly through assisted acquisitions.

###

Senator WIRTH. What did these outside experts report to you, Mr. Wall? Can we get a copy of that report?

Mr. WALL. You certainly can. We don't have the fourth. We have a response from three of them. I don't know whether it's a health problem. I have not had an opportunity to check with the fourth as to why.

Senator WIRTH. But that's probably available and we can get it?

Mr. WALL. Yes. As soon as we get the fourth we can provide it as well and we will provide the others immediately, yes.

[The information referred to follows:]

Observations Regarding the Management and Liquidation of Real Estate Owned in the Southwest Plan

I have been asked by the Federal Home Loan Bank Board ("FHLBB") to comment on the real estate market's perspective of the management and liquidation of the Southwest Plan Real Estate Assets ("SPREAs"). In the course of my review, I have examined materials provided to me by the FHLBB which covered transactions closed through November 18, 1988, have met with representatives of the FHLBB and the Federal Savings and Loan Insurance Corporation ("FSLIC"), and have discussed this matter with various other members of the real estate community.

The problem should not be worked out through the general policy approach. It should not be the goal of the FHLBB to develop a SPREA policy to cover all real estate asset types in all localities in the Southwest under all macro-economic circumstances for the next ten years. First, a large portion of the SPREAs are commercial and development properties, which, unlike residential properties, are in no way homogeneous but rather are unique. Each property should be handled individually. Second, although the real estate market in that region is generally troubled, the degree of trouble is not homogeneous: there are stronger localities and weaker localities. These local differences must be recognized in managing the SPREAs. Third, the future economy and real estate market in the Southwest may change substantially from its current state, either for the good or for the bad, but barring a national recession, it should get better as new starts have slowed. Shifting regional economic and real estate market movements must also be considered in managing the SPREAs. In short, the FHLBB and the FSLIC should not concentrate on establishing SPREA management and liquidation policies but on encouraging the markets themselves to work out the management and liquidation in their own time.

To do otherwise would further diminish the value not only of the liquidating SPREAs but also of the already privately-owned real estate assets. The real estate markets should not be forced to absorb more liquidating assets than they can handle at any time. Fire-sale liquidation of assets should not be pushed. On the other hand, holding off from liquidating any assets would not be realistic and could be ultimately very expensive. The worst thing for the real estate markets would be to have all the assets dumped quickly; the second worst thing would be to have all the assets held indefinitely. The FHLBB and the FSLIC should use their oversight authorities to encourage the acquiring institutions to liquidate the assets in an orderly and timely manner. The FHLBB and the FSLIC should employ experienced and knowledgeable real estate professionals to ensure that this occurs.

Attached is a Goldman Sachs & Co. Research Report on the real estate markets. This is the latest available report and will be updated near mid-year 1989. Real estate markets do not change rapidly and the current situation is about the same as that shown in the report.

Claude M. Ballard

Goldman Sachs

Real Estate Research

October 1988

The Real Estate Report

William B. Brueggeman
A. Russell Jentes

Goldman Sachs

Real Estate Research

William B. Brueggeman
Consulting Director of Real Estate Research
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Goldman Sachs

Real Estate
Research

Executive Summary

General Economic Trends 1

The U.S. economy remains healthy. Higher levels of business investment and strong growth in personal consumption relative to disposable income have fueled the present economic expansion. This environment has generally been favorable for real estate. Retail properties have benefitted from high consumer spending levels, while increased business investment has boosted industrial/warehouse and office property returns.

Flow of Funds 4

Significant reductions have occurred in the volume of credit advanced by mutual funds and money market funds. This change is due to increased consumption and the decline in total wealth caused by the stock market crash of 1987. Commercial banks, savings and loan associations and life insurance companies have regained their relative pre-1986 positions as the dominant lenders to non-financial borrowers. Pension funds are growing increasingly important as sources of funds to financial intermediaries while maintaining their role as direct lenders of long term capital. Foreign sources are lending significantly more funds to domestic credit markets than they did previously. The lion's share of these funds are channelled through private intermediaries, although in the future a greater percentage will probably be advanced directly to domestic borrowers.

Interest Rates 6

Interest rates rose during the second quarter and into the first month of the third quarter, 1988, as did spreads of ten-year bullet loans over ten-year U.S. Treasuries. While Federal Reserve monetary policy will probably remain neutral until the Presidential election, a more restrictive policy is likely thereafter. Developers should seriously consider hedging interest rate risk at this time.

Mortgage Lending 10

The volume of funds advanced to finance commercial real estate continues to fall, principally because of the decline in development activity. Commercial banks and life insurance companies remain significant lenders for commercial development; savings and loan associations have virtually ceased providing such funds. Mortgage funds advanced for the development in multifamily properties have fallen, also a result of the decline in starts.

Goldman Sachs

Real Estate
Research

Office Property Outlook 13

The correction in the office market continued during the first half of 1988. Indicators of demand for office space were generally positive, and the volume of starts continued to trend downward. Vacancy rates, while high by historical standards, appear to have leveled off. Investment performance, although far from outstanding, seems to be stabilizing.

Retail Property Outlook 22

Generally, retail properties performed well. A robust economy and strong personal consumption expenditures have been reflected in higher shopping center sales. The volume of construction fell during this period, continuing a trend begun in mid-1986. Shopping centers reported solid investment returns, especially in California.

Industrial Property Outlook 29

Industrial properties benefitted significantly from the economic growth that characterized the first half of 1988. Industrial production, inventory accumulation, and wholesale trade employment — all indicators of warehouse space demand — were strong relative to their 1986 and 1987 levels. Construction continued to be high by historical standards, although it appears to have reached a plateau. Overall, investment returns were good although properties in some areas reported a slight deterioration in performance. Industrial office properties continued to deliver subpar returns.

Multifamily Property Outlook 38

The multifamily housing market is still in a correction. Although construction starts have declined significantly from their levels in the early to mid-1980s, vacancy rates remain high. The decline in population growth rates among age groups that rent multifamily housing is well under way and is likely to continue. However, if household formation rates were to increase, this trend would be mitigated.

Hotel Property Outlook 44

Hotel performance remained mediocre during the first two quarters of 1988. Although lodging demand increased because of the strong economy and the weak exchange value of the U.S. dollar, room rates increased only moderately and occupancy rates remained low.

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**Foreign Investment and U.S. Real Estate –
The Current Climate**.................................52

International financial markets continued to have an important impact on U.S. real estate markets. International interest rate levels suggest that long term capital will continue to flow from several European and Asian countries, resulting in significant direct purchases of U.S. real estate.

General Economic Trends

The U.S. economy continues to grow at a very healthy rate (see Table 1). Revisions in estimates of gross national product (GNP) recently provided by the Department of Commerce indicate that growth in GNP from 1985 to date was greater than previously thought. This sustained rate of economic expansion can largely be attributed to (1) personal consumption, which has consistently increased more than disposable income, and (2) a surge in business investment caused by the increase in domestic consumption and a significant increase in export activity.

The trend in consumer spending partially accounts for the generally favorable performance of retail property investments in most regions of the country (discussed in more detail later). Forecasts by the Goldman Sachs Economic Research Group (GSER) indicate, however, that a much closer correspondence between growth in income and consumption should occur during the latter half of 1988, with consumption eventually increasing less than disposable income. This change appears to be under way, as indicated by the annual rate of growth in consumption and income for the most recent four quarters (ended with the second quarter of 1988, see Table 1). This lower rate of growth should eventually have only a slight dampening effect on retail sales.

Significant increases have occurred in fixed business investment and inventory accumulation as well as in industrial production and capacity utilization. These increases, if sustained, should affect the performance of industrial/warehouse properties favorably, barring an oversupply in the development of such space. Office properties should also be favorably affected by increases in business investment and indirectly by consumer spending. The extent of these effects on office properties is more difficult to assess because of current supply conditions in most markets. Total employment continues to grow and the unemployment rate continues to decline, which should positively affect absorption rates for most types of real property uses. The decline in the rate of increase in net government outlays brought about by the influence of the Balanced Budget and Emergency Deficit Control Act of 1985 (Graham-Rudman) appears to be more than offset by growth in outlays by both consumers and

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business. The decline in housing starts is a result of a significant reduction in multifamily starts, as single-family housing starts have increased (See Table 1).

Improving U.S. exports should help offset the reduction in consumption growth expected to occur later this year. As shown in Table 1, exports have grown dramatically since 1986 and GSE expects this growth to remain positive. However, upward pressure on domestic prices, as indicated by recent increases in both the Consumer Price Index (CPI) and Producer Price Index (not shown), coupled with rising interest rates, are areas of concern, particularly for prospects of continued growth in business investment and exports. Relatively low rates of price inflation in countries making up our primary trading partners and interest-rate policies in those countries make estimates of U.S. real export growth difficult to forecast at this time.

As also shown in Table 1, development of both commercial real estate and multifamily housing continues to decrease. This decline is in response to previous overbuilding in most urban markets, and in the case of multifamily starts, it is also because of a reduction in demand by younger individuals. These trends will be discussed in more detail later.

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Table 1

Summary of Economic Indicators

	1980-1985	1986	1987	2Q87-2Q88	1988E(a)
GNP	2.6	2.8	3.4	4.5	3.8
Households					
Disposable Income	2.8	3.9	1.7	2.9	3.5
Personal Consumption	3.3	4.3	2.7	2.4	2.6
BUSINESS					
[illegible]					
[illegible] (adj.)	15.0	3.4	-6.2	1.0	5.8
[illegible] Investment	4.6	1.0	4.9	11.3	4.1
[illegible] Investment	3.6	-4.5	2.8	10.8	9.8
[illegible] Inventories	1.5	2.1	2.2	4.0	4.1
GOVERNMENT					
Purchases	3.3	4.0	2.6	1.4	0.9
FOREIGN TRADE					
Exports	$394.9	$515.9	$556.7	$585.4	$96.0
% Change	7.3	9.4	7.9	9.9	7.1
Imports	$368.4	$378.4	$427.8	$471.5	500.3
% Change	-1.1	3.0	13.1	19.5	17.0
OTHER					
Consumer Price Index	5.5	1.9	3.7	4.0	4.2
Hourly Wages	5.9	4.3	4.0	4.7	4.4
Civilian Employment	1.5	2.1	2.8	2.6	2.6
Civilian Unemployment	8.3	7.0	6.2	5.7	5.5
Housing Starts					
(mil. units)	1.5	1.8	1.6	1.5	1.5
% Change	6.0	4.1	-9.8	-11.0	-11.0
Industrial Production	2.6	1.1	3.8	5.7	5.9
Capacity Utilization Rate	76.6	79.8	81.1	82.4	83.5
Money Supply (M2)	9.4	9.4	4.0	4.0	5.0
REAL ESTATE DEVELOPMENT					
Commercial (Sq. Ft.)	7.2	-8.9	-4.1	-3.0	-4.0
Multi-Family (units)	11.1	-10.5	-25.2	-5.8	-5.0

(a) Goldman, Sachs Economic Research
(Average annual rates of change in real data, unless otherwise indicated.)
Sources: Data Resources Inc., F.W. Dodge, U.S. Department of Commerce,
U.S. Department of Labor and Federal Reserve System.

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Flow of Funds

Table 2 contains data summarizing (1) net credit advanced directly to nonfinancial businesses by private financial institutions and (2) the sources from which those funds were obtained. A number of trends are apparent from the data. The reversal of large amounts of credit advanced through intermediaries during 1986 continues in response to lower savings rates (higher consumption) and a decline in total wealth due to the 1987 stock market decline. As a part of this reversal, significant reductions have occurred in credit funds advanced by mutual funds and money market funds. As a result, commercial banks, savings and loan associations, and life insurance companies have regained their relative pre-1986 positions as the dominant direct providers of credit to non-financial borrowers. Commercial banks currently show the largest increase in total funds advanced to all borrowers, with life insurance companies and savings and loan associations also showing major increases. Commercial banks and life insurance companies currently appear to be the most readily available source of mortgage funds for borrowers.

In addition to becoming a more direct lender, pension funds continue to increase in importance as sources of funds to financial intermediaries (see bottom half of Table 2). Pension funds unquestionably will remain an important source of longer-term credit, either directly or through intermediaries, for some time to come. It is also important to note that foreign sources have recently significantly increased funds provided to credit markets relative to other sources. While these funds continue to be channeled primarily through private intermediaries, it is likely that a larger share eventually will be advanced directly to domestic borrowers. Another important change in funds flow that began in 1987, and may continue during the second half of 1988, is shown in data categorized as "credit borrowing by intermediaries." This latter source includes advances made by the FSLIC and other federally related agencies to troubled financial institutions. In some cases, these advances are not likely to become a source of funds for lending but a supplement for interest and operating costs for recipients of those advances.

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Table 2

Net Funds Advanced to Credit Markets Through Private Intermediates

	1985	1986	1987	1Q87–1Q88
Net Funds Advanced (billions)	$579.5	$726.9	$558.7	$596.1
Change from Previous Period	3.5%	24.4%	−23.1%	−15.7%
Advanced By				
[illegible]	32.2	26.8	24.4	33.3
[illegible]	10.3	10.1	16.7	16.3
[illegible]	4.0	4.5	7.6	6.3
[illegible]anies	18.3	17.2	21.4	19.1
[illegible] Pension Funds	8.6	7.2	10.3	9.6
[illegible]	2.1	5.1	6.8	3.9
[illegible] Companies/Other	10.3	7.7	7.9	9.4
Money Market Funds	14.3	21.6	4.9	2.2
Total	100.00%	100.00%	100.00%	100.00%
Provided By				
Private Domestic Deposits and RPs	36.8	37.3	29.1	40.5
Credit Borrowing	16.8	16.1	20.8	15.1
Foreign Sources	3.4	1.8	7.9	3.6
Insurance & Pension Services	24.3	21.0	26.5	26.2
Treasury Balances/Other	18.7	23.8	15.8	14.6
Total	100.00%	100.00%	100.00%	100.00%

Sources: Data Resources, Inc., Federal Reserve System-Flow of Funds Accounts.

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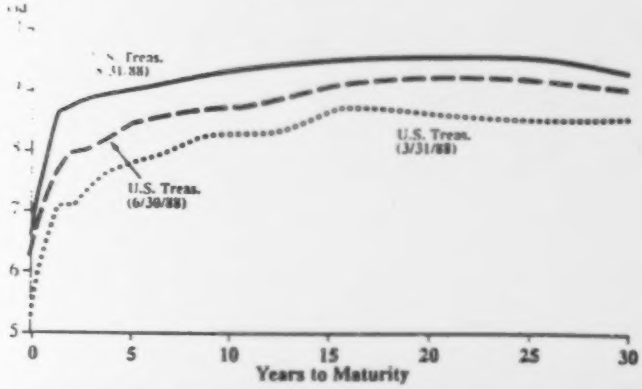
Interest Rates

As shown in Figure 1, interest rates have continued their upward movement through the end of the second quarter and into the first month of the third quarter. Short-term Treasuries increased approximately 150 basis points and long-term rates increased approximately 50 basis points from the end of the first quarter to the beginning of September 1988.

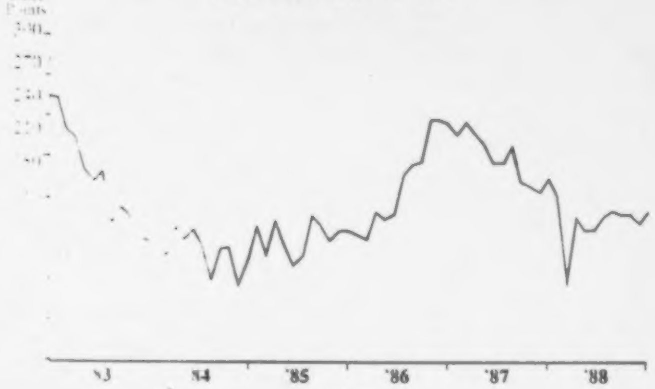
Figure 1
Yield Curves



Regarding real estate loans. Figure 2 shows the spread between ten-year bullet loans and ten-year Treasuries through July 1988. The increase in spreads that started in the third quarter of 1987 continues to drift upward. GSE believes that Federal Reserve policy will remain neutral until after the Presidential election, after restricting monetary growth earlier this year. However, a more restrictive policy is likely to occur after the election, which could result in rising interest rates. Given the prospect of rising interest rates and the uncertainty about their variability, developers and investors should consider hedging this risk for properties currently financed at floating rates or for projects about to be financed.

Figure 2

Spread of Ten–Year Bullet Loans Over Ten–Year Treasuries



[illegible] Barron's.

Managing Interest-Rate Risk

With growing uncertainty regarding interest rates, borrowers seeking to finance real estate development and acquisitions would do well to examine alternative methods that can be used to manage interest-rate risk. While there are numerous ways to approach this problem, borrowers are using interest-rate swaps and caps instead of bearing the risk associated with loans made at floating rates of interest. The market for swaps and caps has grown tremendously in recent years is very well developed. The current volume of interest-rate swaps is estimated to be at least $800–$900 billion annually, up from about $100 million six years ago.

To illustrate the trade-offs between using swaps, caps, and floating rates when financing, Figure 3 shows the effective cost of each under different interest-rate scenarios. If, for example, on September 12, 1988, a borrower sought a three-year financing commitment and considered taking a six-month LIBOR-based loan, the prevailing rate would have been about 8.74%. However, depending on the subsequent changes in LIBOR, the effective

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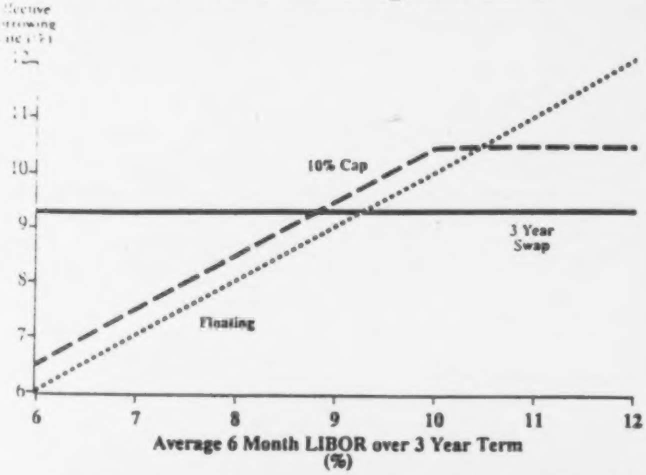
cost of floating rate financing could vary over a wide range (6% - 12% is used for purposes of illustration in Figure 3). Alternatively, the borrower could have entered into an interest-rate swap agreement for about 78 basis points over three-year Treasuries, thereby locking in a 9.32% effective cost over the term of the loan. With a swap then, insurance against interest-rate risk for three-years would have been purchased at a cost of 58 basis points over the prevailing LIBOR rate. Figure 3 shows that if over the three-year term, the average of floating rates is greater than 9.32%, the borrower would be worse off without the swap, and vice versa.

Figure 3

Relative Cost of Financing Alternatives



As an alternative to the swap, a borrower could have purchased an interest-rate cap of 10% for approximately 126 basis points up front. Under this arrangement, the borrower would pay LIBOR up to a maximum of 10%, the point at which the rate would be capped. The maximum effective cost that the borrower would pay for the three-year loan in this case would not exceed 10.5% (10.0% plus a fee of 126 basis points, or 50 basis points when amortized over three years.). This means that if the average of floating rates over the term exceeds 10.5%, the borrower would be better off with the cap. Alternatively, if the average exceeds 8.83%, the borrower would be better off with the swap. This also means, however, that if the borrower wanted to purchase protection against interest-rate risk and the floating rate averaged below 8.83, the cap would have been the better choice. Hence, the trade-off between swaps and caps becomes clear. If a cap is purchased, the borrower still benefits from downward movements in interest rates. If a swap is purchased, the borrower locks in a fixed rate, but does not benefit if rates decline.

Under either approach, the borrower obtains protection from potentially harmful interest-rate risk. If a cap is chosen, a borrower may also choose to sell a "floor" in combination with a cap to reduce the cost of the cap. Under this agreement, should interest rates fall below the "floor," the borrower would not benefit from any declines below the "floor" rate. The fee received from selling the "floor" would be used to reduce the cost of the cap.

Bullet loans, which also provide fixed-rate financing, are an alternative to either a swap or a cap. However, borrowers should be aware that if it becomes advantageous to prepay a loan, yield maintenance provisions imposed by fixed-rate lenders on prepayment may drive the cost of bullet loans much higher than the cost of a swap. This will generally be true when both the bullet loan and the swap are originated at the same pay rate and may also be true even when a bullet loan is originated at an interest rate below that of a swap.[1]

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[1] For a further discussion see, "Yield Maintenance Versus Swap Termination" by Swift Barnes and Randall Zisler, Goldman Sachs Real Estate Research, August 15, 1987.

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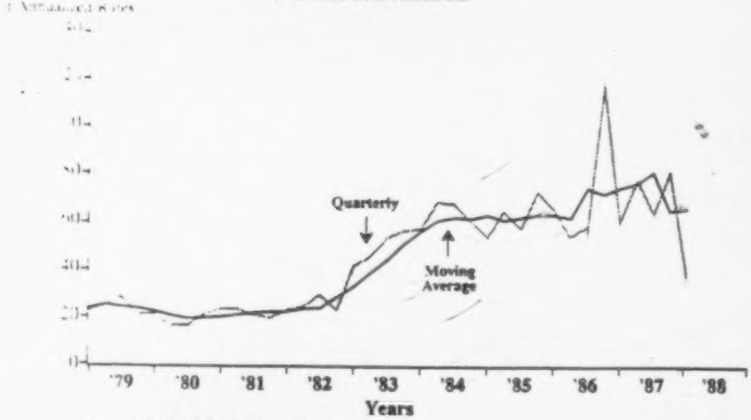
Mortgage Lending

With respect to funds advanced for mortgages secured by income-producing properties, Figure 4 shows net funds advanced for mortgages secured by commercial properties through the end of the first quarter of 1988. Funds advanced to finance such properties continue to trend downward over time because of the general decline in total development activity.

Figure 4

Net Commercial Mortgage Funds Advanced



Source: Dodge/DRI Construction and Real Estate Information Service.

As shown in Table 3, the dominant, current provider of funds for commercial mortgage loans is clearly commercial banks, with life insurance companies also continuing to provide a significant proportion of funds advanced for commercial development. As might be expected, savings and loans, when considered as a group, have virtually ceased providing such funds.

Mortgage funds advanced for the development of multifamily properties have unambiguously declined and continue to fall. The trend shown in Figure 5 is a direct result of the significant decline

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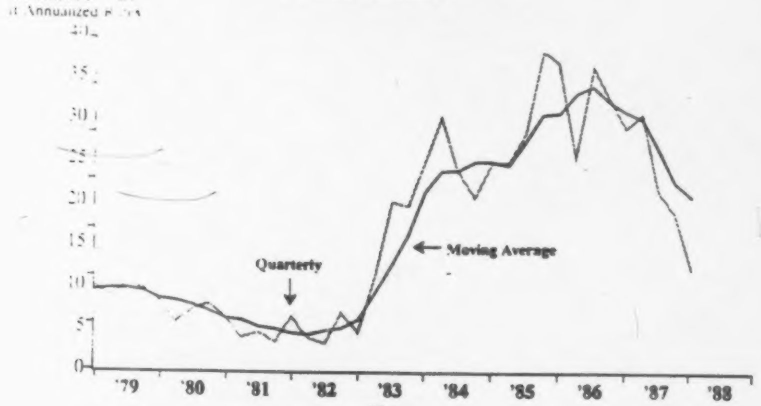
in multifamily housing starts. The outlook for this sector of the real estate development industry remains cloudy because of uncertainty over changes in household formations and because of excess supply that continues as a result of federal income tax policies that prevailed in the early 1980s. As data in Table 3 indicate, the precipitous decline in funds formerly advanced for multifamily development by savings and loan associations continues. Commercial banks, mutual savings banks, and life insurance companies are now providing most of the funding for a smaller total volume of multifamily development.

Figure 5
Net Multifamily Mortgage
Funds Advanced



Source: Dodge/DRI Construction and
Real Estate Information Service.

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Table 3

Net Mortgages Advanced — Income Producing Properties

	1985	1986	1987	1Q87-1Q88
Commercial Mortgages				
Net Advanced (billions)	$58.2	$70.4	$67.7	$62.6
% Chg from Previous Period	-2.5%	20.9%	-3.8%	-12.1%
% Advanced By				
Commercial Banks	48.3	58.6	63.9	62.4
Savings and Loans	14.7	6.4	-0.7	1.1
Mutual Savings Banks	3.0	1.2	9.0	6.1
Life and Other Insurance Cos.	29.5	32.1	26.5	29.0
Other	4.5	1.7	1.3	1.5
Total	100.00%	100.00%	100.00%	100.00%
Multifamily Mortgages				
Net Advanced (billions)	$19.2	$16.5	$12.3	$10.9
% Chg from Previous Period	13.3%	-14.2%	-25.2%	-25.1%
% Advanced By				
Commercial Banks	16.2	45.0	34.8	35.1
Savings and Loans	68.2	35.1	21.4	17.5
Mutual Savings Banks	6.9	8.8	40.1	35.2
Life Companies	5.0	6.4	12.7	14.9
Other	3.7	4.7	-9.0	-2.7
Total	100.00%	100.00%	100.00%	100.00%

Sources: Data Resources, Inc., Federal Reserve System-Flow of Funds Accounts.

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Office Property Outlook

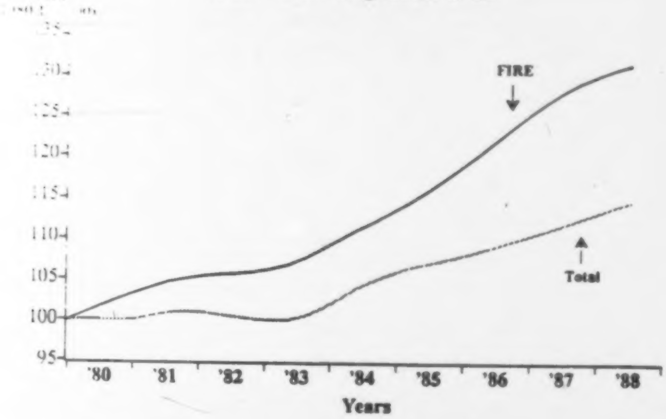
Demand Indicators

One indirect indicator of the demand for office space — employment in finance, insurance, and real estate industries (FIRE) — continued to increase through the second quarter of 1988. The trend in total FIRE employment and total civilian employment since 1980 is shown in Figure 6. While it is reasonable to assume that changes in employment are positively related to the demand for office space, this relationship is not necessarily proportional[2] to changes in employment or limited only to expansion in businesses represented by FIRE employment. Given this caveat, data summarizing trends in employment are shown in Table 4.

Figure 6

FIRE and Total Employment

1980 – Second Quarter 1988



Total civilian employment increased to 114.6 million at the end of the second quarter of 1988 from 99.5 million at the end of 1980 while FIRE employment increased to 6.7 million from 5.2 million

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[2] Depending on the nature of technological change brought by computers and other innovations and the relative costs of land, labor, and capital inputs, demand for office space can change at an increasing or decreasing rate relative to employment over time.

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over the same period. These increases translate into annual growth rates in FIRE employment (3.4%) that exceeded that of total employment (1.9%). However, as shown for the four most recent quarters ending with the second quarter of 1988, and for second quarter of 1988 data, rates of increase in *both* FIRE and total employment declined. Also, for the first time since 1980, FIRE employment increased at a lower rate than the increase in total employment during the second quarter of 1988. This change is believed to be a result of increased consumer spending on durable goods and increased exports of manufacturing goods, which have stimulated growth in non-service employment. These changes in employment patterns are shown in Figure 7 for the period corresponding to the latter part of 1987 and into 1988. However, it should again be pointed out that both growth rates remain positive.

Figure 7

Rate of Change in FIRE and Total Employment

1980 – Second Quarter 1988

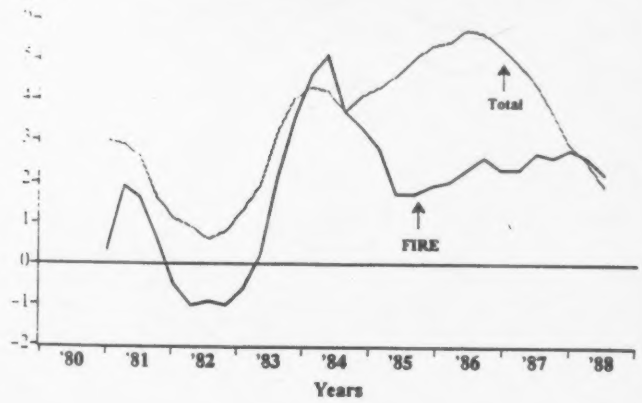

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Table 4

Summary of Employment Growth

	1980	2Q1988	Growth(b)
Total Civilian Employment(a)	99.5	114.6	1.9%
FIRE Employment(a)	5.2	6.7	3.4%
FIRE Relative to Total	5.2%	5.8%	—

Selected Growth Rates	1980–1985	1986	1987	2Q87–2Q88	2Q88
Total Civilian Employment	1.5%	2.3%	2.6%	2.6%	1.4%
FIRE Employment	2.9	5.5	4.3	2.9	1.2

(a) Millions
(b) Annual rates: compounded quarterly.
Source: Data Resources, Inc.

Supply of Office Space

The general trend in office construction starts continues downward. as shown in Figure 8. Estimated increases in the addition of new space to the stock of existing office buildings are as follows:

	1980–1985	1986	1987	2Q87–2Q88
Change in Starts	7.4%	-16.5%	-5.7%	-8.7%

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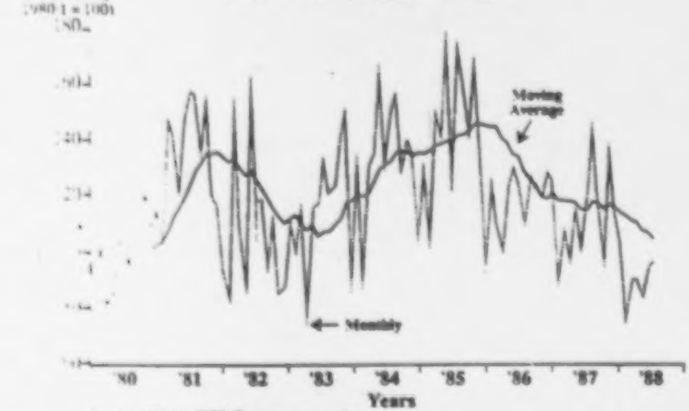
Figure 8
Office Construction Starts
1980 – Second Quarter 1988



Source: Dodge/DRI Construction and Real Estate Information Service.

For the first half of 1988, a handful of cities, led by Washington, D.C., accounted for a significant share of this construction (see Table 5).

Table 5

Top Ten MSAs For Office Construction, First-Half 1988

	% of Total
Washington, D.C.	13.0%
Los Angeles, California	7.7
Detroit, Michigan	6.5
Atlanta, Georgia	6.3
Boston, Massachusetts	6.2
Chicago, Illinois	5.4
Baltimore, Maryland	3.6
Philadelphia, Pennsylvania	2.7
Phoenix, Arizona	2.5
Kansas City, Missouri – Kansas	2.2

Sources: Dodge/DRI Construction and Real Estate Information Service.

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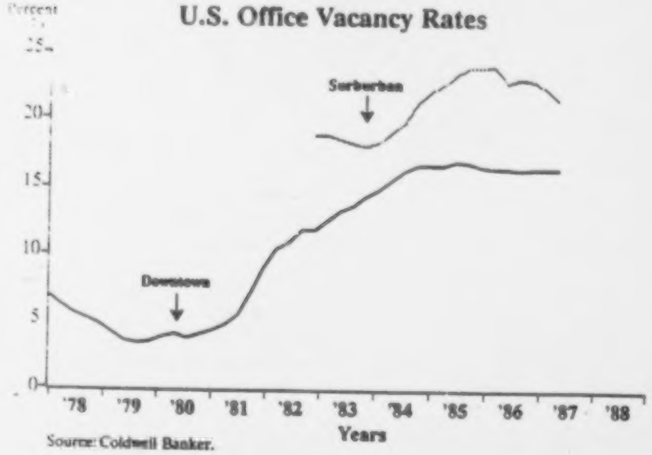
Based on the increases shown for both total and FIRE employment, and the reduction in the rate of addition to the supply of office space, the major correction under way in the office market continues. While recent total additions to the supply of new office space are now less than 1980 levels, excess supply continues to exist in many urban markets because of relatively long lags between past construction starts and tenant occupancy.

Figure 9 shows that downtown vacancy rates continue to remain stable, having leveled off at approximately 16.5% for the past 12 quarters. With the decline in construction starts, vacancy rates should eventually trend downward, unless a national decline in employment occurs. However, in regions affected by the decline in energy prices, major employment relocations to other regions are still occurring. This labor shift will result in significant amounts of vacant space in affected areas for some time. The excess supply of space in these markets will also tend to place a "floor" under national vacancy rates for some time. Vacancy rates in markets unaffected by the decline in the energy sector should begin to improve over time relative to the national average. Table 6 provides a breakdown of cities showing major changes in vacancy rates during the second quarter of 1988.

Figure 9
U.S. Office Vacancy Rates



Source: Coldwell Banker.

Table 6

Office Vacancy Rates
Second-Quarter 1988

	Downtown		Suburban	
Lowest				
Honolulu	5.3%		St. Louis	12.4%
Toronto	6.1		Long Island	13.5
Sacramento	6.6		Baltimore	13.7
Hartford	7.0		Washington, D.C.	15.4
			Los Angeles	15.7
Highest				
[illegible]	37.9%		Austin	41.1%
Oklahoma City	35.0		Houston	34.1
Denver	29.1		Palm Beach(a)	31.4
Kansas City	26.1		Mid-New Jersey(a)	31.2
New Orleans	25.9		Dallas	30.1
Greatest Declines				
Honolulu	-3.3 to 5.3%		Mid-New Jersey	-5.6 to 31.2%
Sacramento	-3.3 to 6.6%		San Jose	-3.5 to 19.9%
			Las Vegas	-4.1 to 17.0%
			Orlando	-3.2 to 19.7%
Greatest Increases				
Indianapolis	+3.6 to 16.8%		No material change	
Tampa	+3.4 to 16.5%			
National Average	16.3%, no change		21.5%, down slightly from the first quarter	

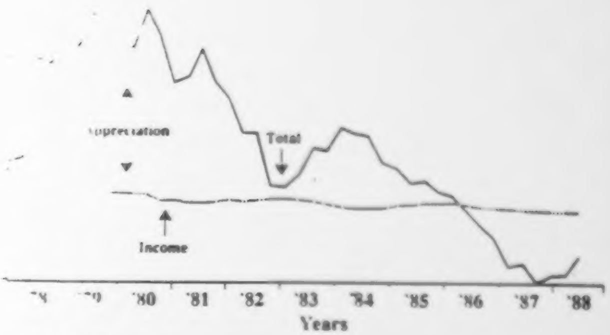
(a) County data.
Source: Coldwell Banker.

Investment Performance - Office

Given the trends in employment, construction starts, and vacancies, total investment returns on office properties remain low, but appear to be stabilizing. Figure 10 shows the trend in total investment returns for unleveraged office properties through the second quarter of 1988, as well as trends in the income and appreciation components of those returns. These results are based on a portfolio of investment-grade properties acquired and managed by pension fund advisors. However, these returns many not be indicative of individual property returns, such as landmark or trophy properties and other property types not contained in the portfolio. The income component of total returns remains stable, while the appreciation component continues the decline started in mid-1984.

Figure 10

U.S. Office Returns



Source: FRC Company.

Based on data shown in Table 7 for the second quarter of 1988, total returns for all properties included in the index show mixed results compared with returns in 1987. With the exception of properties in the western region, where returns appear to be trending upward, returns in all other regions declined. In the southern region, returns remained negative, however, this trend appears to be moderating. Properties in this region showed a 1.6% decline during the second quarter compared with a 4.5% decline in total return for the four quarters ended in the second quarter of 1988, and a 14.6% decline during 1987. Return data for the S&P 500, corporate bonds, and changes in the CPI are also provided in Table 7.[3]

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[3] These data are provided as general indicators of trends only, as they are not strictly comparable with unleveraged real estate returns. No adjustments have been made for risk.

Table 7

Office Property Investment Returns

	1980-85			1986			1987			2087 to 2088			2088		
	Total	Inc.	App.	Total	Inc.	App.	Total	Inc.	App.	Total	Inc.	App.	Total	Inc.	App.
National	12.7%	7.2%	5.2%	4.2%	6.8%	-2.5%	0.5%	6.6%	-5.8%	2.5%	6.5%	-3.8%	3.7%	6.3%	-2.6%
Midwest	11.6	7.5	3.8	7.5	7.2	0.3	6.9	7.4	0.5	5.6	6.4	-0.7	3.5	5.7	-1.9
East	16.5	7.1	8.9	11.6	7.6	3.8	11.4	7.0	4.1	7.6	7.1	0.5	5.7	7.6	-1.9
South	10.3	7.2	3.0	-2.8	5.7	-8.2	-14.6	5.6	19.4	4.5	5.7	-9.9	-1.6	5.5	-7.2
West	12.4	7.3	4.8	1.5	6.7	-4.9	-0.1	6.5	6.4	1.0	6.5	-5.2	4.7	6.1	-1.2
CPI	5.5%			1.9%			3.7%			4.0%			4.5%		
S&P 500	14.7			18.5			5.2			-7.1			26.4		
Corp. Bonds	17.8			19.8			-0.3			8.9			9.2		

(a)Annualized

Source: NCREIF Report, Frank Russell Co., Ibbotson and Assoc.

Estimated second quarter 1988 property appreciation rates were negative for all regions of the country. Estimated appreciation rates in the East have also become negative for the first time. These results indicate that uniformly negative rates of estimated appreciation are occurring, even though total returns remain positive (with the exception of returns in the South). Based on this pattern, it is apparent that capitalization rates used by appraisers when estimating property values are generally trending upward for office buildings.

In summary, with total construction starts declining, employment increasing (albeit at a decreasing rate), and vacancy rates unchanged, the correction in investment returns on office properties is continuing; supply and demand conditions appear to be stabilizing.

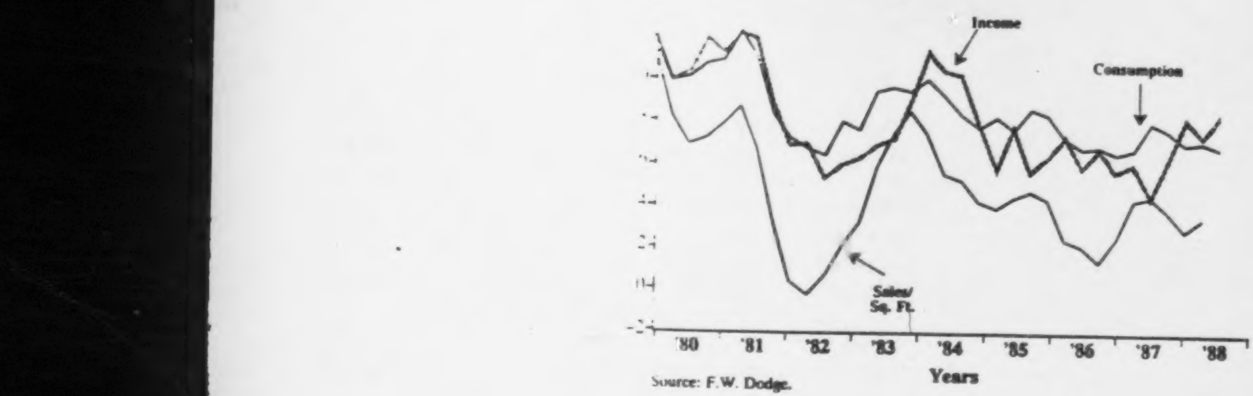
Retail Property Outlook

Demand Indicators

As previously indicated, data from 1980 through the second quarter of 1988 show that personal consumption expenditures have increased significantly. This relatively high rate of expenditure has translated directly into higher sales per square foot of retail space (see Figure 11).

Figure 11

Growth in Retail Sales per Square Foot, Personal Consumption, and Disposable Income



Source: F.W. Dodge.

Table 8 contains comparative data used to graph the relationships shown in Figure 11.

Table 8

Changes in Personal Consumption, Disposable Income, and Retail Sales Per Square Foot (a)

	1980–1985	1986	1987	2Q87 2Q88	1988E(a)
Disposable Income	8.2%	6.4%	6.3%	8.5%	5.5%
Consumption	8.7	6.8	7.3	6.6	8.0
Sales Per Sq. Ft.	4.8	2.5	3.8	3.4	7.3

(a) Based on nominal values.
Sources: Data Resources, Inc., F.W. Dodge.

When compared with both income and consumption, growth in sales per square foot of retail space continued to show strength during the second quarter of 1988. This long period of sustained consumption has resulted in higher lease rental rates and overages for owners of retail shopping centers and malls. It has also been a significant factor in merger and acquisition activity between developers and retail merchandisers. Based on the strong growth in retail spending, this sector of the commercial real estate market continues to outperform all others. Retail sales have also continued to produce revenues for merchandisers in spite of the current debate over changes in women's fashions. Further, the "hypermart" experiments undertaken to date seem to have been generally successful.[4]

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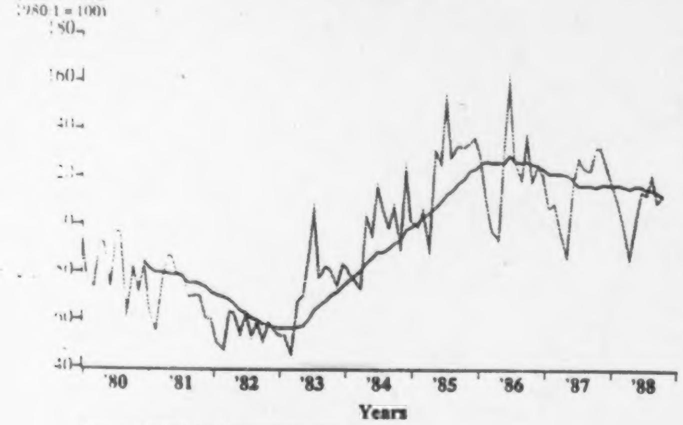
[4] For details, refer to "The Woman's Apparel Retailing Debacle: Why?" June 8, 1988 and "New Retailing Formats Changing American Shopping Habits," June 21, 1988 by Joseph H. Ellis, Goldman Sachs Investment Research.

Supply Conditions - Retail

In the first half of 1988, retail starts continued their decline started in mid-1986. Figure 12 indicates the trend in retail construction starts.

Figure 12

Retail Construction Starts



Source: Dodge/DRI Construction and Real Estate Information Service.

Estimates of rates of change in retail space for selected periods are as follows:

	1980–1985	1986	1987	2Q87–2Q88
Change in Starts	8.4%	–4.0%	–4.1%	-2.3%

No one city accounted for a very large portion of retail space started during the first two quarters of 1988. The top 5 MSAs, ranked by area of retail starts, have similar shares of the nation's retail square footage under construction (see Table 9).

Table 9

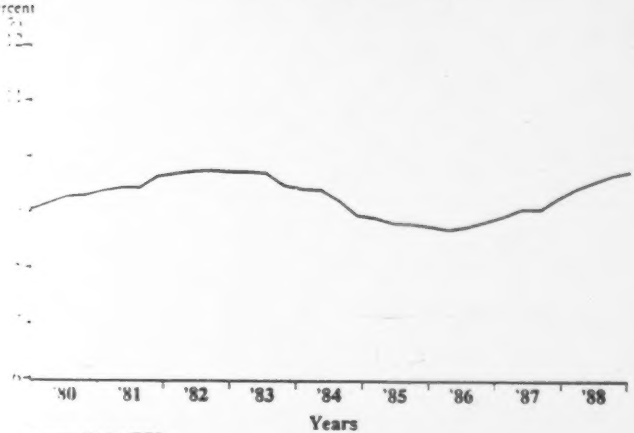
Top Ten MSAs For Retail Construction, First-Half 1988

	% of Total
[illegible] Illinois	5.8%
[illegible] Florida	5.8
Los Angeles, California	5.5
Riverside – San Bernadino – Ontario, California	5.2
Washington, D.C.	5.0
Phoenix, Arizona	4.5
Detroit, Michigan	4.4
Philadelphia, Pennsylvania	4.0
Nashville – Davidson, Tennessee	3.7
Anaheim – Santa Ana – Garden Grove, California	2.7

Source: Dodge DRI Construction and Real Estate Information Service.

Retail vacancy rates have not changed materially, but do appear to be trending up in an area of 9.5%. Figure 13 provides a comparison of current and previous vacancy rates.

Figure 13
Retail Vacancy Rates



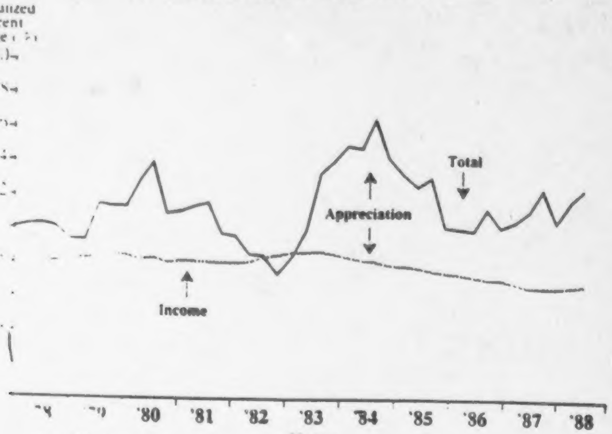
Source: Dodge/DRI.

Investment Performance – Retail

Generally, investments in retail property continue to perform well (see Figure 14). Estimated rates of appreciation have surged in the western region, where such rates have sustained total returns at levels higher than reported in any period during the 1980s. As shown in Table 10, total returns for the four quarters ended with the second quarter of 1988 were 17%. Second-quarter 1988 returns, when annualized, were 20.2%. This represents a substantial estimated return for unleveraged real estate. These returns, driven primarily by shopping malls in California, continue to show the highest estimated returns relative to other regions. Estimated returns in the eastern United States, though still strong relative to other regions, have moderated relative to returns reported in previous periods. Estimated returns in the Midwest have continued to decline relative to other regions and previous periods. Negative returns in the South appear to have reversed from previous rates of decline.

Figure 14

U.S. Retail Returns



Source: FRC Company.

Table 10

Retail Property Investment Returns

	1980–85			1986			1987			2087 to 2088			2088		
	Total	Inc.	App.	Total	Inc.	App.	Total	Inc.	App.	Total	Inc.	App.	Total	Inc.	App.
National	12.7%	8.4%	3.4%	11.2%	7.3%	3.7%	11.8%	6.8%	4.7%	13.2%	7.0%	5.9%	14.1%	7.2%	7.1%
Midwest	10.0	9.2	0.8	12.0	8.3	3.6	15.3	8.8	6.0	10.8	8.7	1.9	6.6	8.2	-1.6
East	14.5	9.0	5.2	16.9	7.6	8.7	15.5	6.4	[illegible]	[illegible]	6.8	6.6	13.1	5.9	7.1
South	10.9	8.5	2.3	9.9	7.5	2.3	6.7	6.8	0.1	[illegible]	7.0	0.6	8.1	6.8	1.3
West	12.6	7.9	4.4	10.3	6.9	3.3	13.0	6.5	6.1	[illegible]	6.8	9.7	20.2	7.3	12.9
CPI	5.5%			1.9%			3.7%			4.0%			4.5%		
S&P 500	14.7			18.5			5.2			7.1			26.4		
Corp. Bonds	17.8			19.8			-0.3			8.9			9.2		

Sources: NCREIF Report, Frank Russell Co., Ibbotson and Assoc.

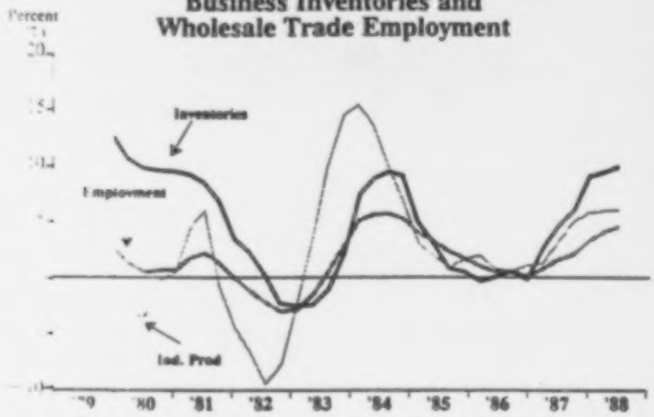
Industrial Property Outlook

Demand Indicators

Indicators of demand for industrial-warehouse space remain generally positive. Table 11 contains data showing percentage changes in industrial production, inventories, and wholesale trade employment. These changes are consistent with growth in outlays for fixed business investment, spending on consumer durables, and export activities discussed earlier. Industrial production, inventory accumulation, and wholesale trade employment now compare very favorably with the low rates of growth that occurred during 1986 and 1987, when the production of services was increasing relative to manufactured goods. This trend is clearly positive for short-run absorption of warehouse space, particularly in areas affected by export activity. However, the highly cyclical nature of inventory changes (see Figure 15), and uncertainty regarding the continued resurgence in manufacturing versus services, make prospects for the absorption of industrial-warehouse space more difficult to assess over the longer run. Continued growth in domestic demand for U.S.-manufactured goods, and increases in the export of those goods will play a vital role in future expansion of industrial facilities and necessary storage and distribution space.

Figure 15

Changes in Industrial Production, Business Inventories and Wholesale Trade Employment



Source: Data Resources, Inc.

Table 11

Changes in Economic Indicators of Demand for Industrial-Warehouse Space

	1980-85	1986	1987	2Q87-2Q88
Changes in				
Industrial Production	2.6%	1.1%	3.8%	5.7%
Total Business Inventories	3.8	0.1	5.6	8.7
Wholesale Trade Employment	1.6	0.7	2.1	3.6

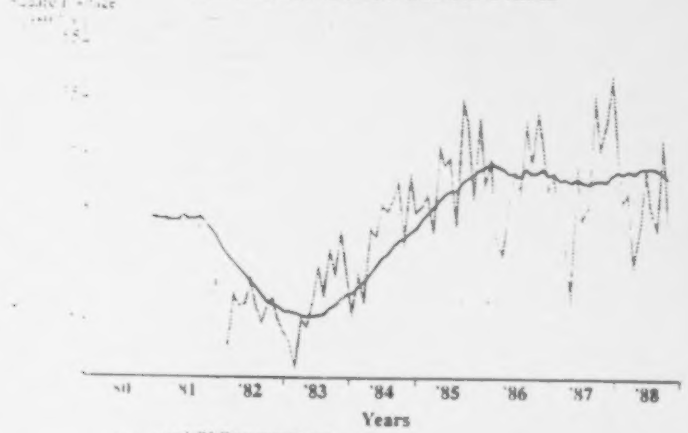
Source: Data Resources Inc.

Supply of Warehouse Space

Figure 16 shows that the construction of warehouse space has generally leveled off, with a recent tendency to decline slightly.

Figure 16

Warehouse Construction Starts



Source: DRI Construction and Real Estate Information Service.

Data on recent additions to the supply of warehouse space are as follows:

	1980–1985	1986	1987	2Q87–2Q88
Change in Starts	4.0%	-5.5%	3.3%	3.0%

Two MSAs dominated warehouse construction activity during the first half of 1988. Riverside-San Bernadino and Los Angeles. California accounted for more than 24% of the total amount under construction during that period. Atlanta. Georgia supported only 6.2% of the nation's warehouse construction. a distant third. (see Table 12)

Table 12

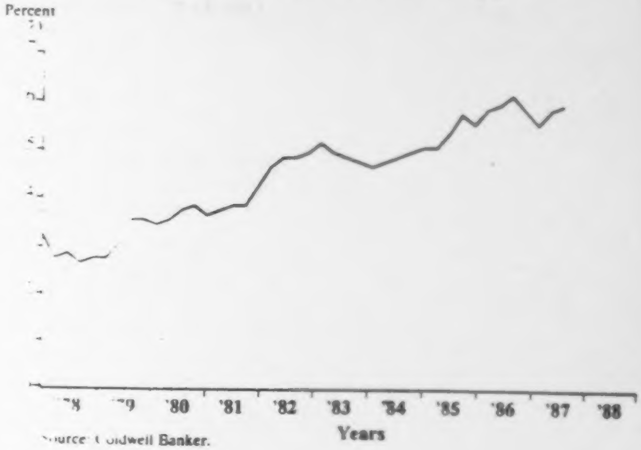
Top Ten MSAs For Warehouse Construction, First-Half 1988

	% of Total
Riverside – San Bernadino – Ontario, California	12.9%
Los Angeles, California	11.3
Atlanta, Georgia	6.2
Anaheim – Santa Ana – Garden Grove, California	4.4
Chicago, Illinois	4.3
Detroit, Michigan	3.4
Phoenix, Arizona	3.3
Washington, D.C.	2.9
San Francisco – Oakland, California	2.7
Baltimore, Maryland	2.4

Sources: Dodge/DRI Construction and Real Estate Information Service.

Vacancy rates, which have been trending upward, appear to be stabilizing at about 6% (See Figure 17). Significant changes in vacancy rates in major U.S. cities are detailed in Table 13. The very low vacancy rates in the Baltimore-Washington, D.C. and Portland areas, all export-related markets, should be noted. These areas have consistently shown significant percentage declines in vacant space in recent periods.

Figure 17
U.S. Industrial Vacancy Rates



Source: Coldwell Banker.

Table 13

Industrial Vacancy Rates
Second-Quarter 1988

Lowest		**Highest**	
Washington, D.C.	.9%	Miami	10.9%
Baltimore	1.8%	Houston	10.8%
Portland	2.2%	North-Central California(a)	8.7%
Greatest Declines		**Greatest Increases**	
Kansas City	-1.2 to 5.7%	Charlotte	1.2 to 7.5%
Miami	-1.1 to 10.9%	Philadelphia	1.0 to 3.6%
Nashville	-1.0 to 3.2%		
National Average	5.9%		

(a) County data.

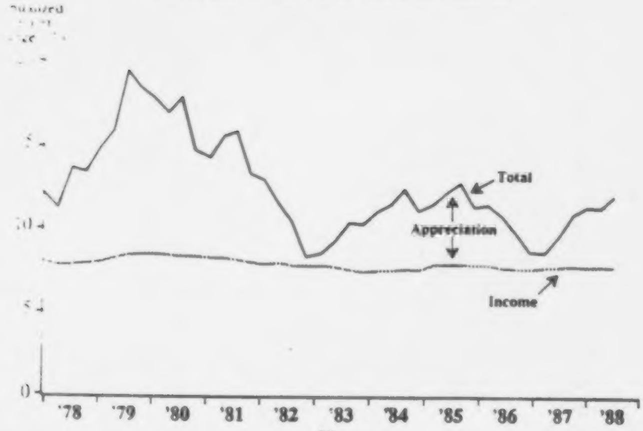
Source: Coldwell Banker.

Investment Performance – Industrial–Warehouse

Returns on industrial-warehouse properties continued to increase from 1987 levels (see Figure 18). However, some softening in performance in most regions may be under way, as shown in results for the second quarter of 1988 (see Table 14). As was the case with office properties, declines in expected appreciation are moderating to a degree in the South. Overall investment performance, however, is consistent with the general trends in industrial production and inventory changes pointed out previously. Given the leveling-off in the supply of additional warehouse space, future investment returns should change closely with industrial output.

Figure 18

U.S. Industrial Warehouse Returns



Source: FRC Company

Table 14

Industrial-Warehouse Property Investment Returns

	1980-85			1986			1987			2Q87 to 2Q88			2Q88(a)		
	Total	**Inc.**	**App.**	**Total**	**Inc.**	**App.**	**Total**	**Inc.**	**App.**	**Total**	**Inc.**	**App.**	**Total**	**Inc.**	**App.**
National	12.7%	7.9%	3.7%	8.7%	7.8%	0.9%	11.8%	8.0%	3.5%	12.5%	7.9%	4.4%	8.6%	7.8%	8.0%
Midwest	8.7	8.0	0.6	10.6	8.2	2.1	13.0	8.3	4.4	15.0	8.5	6.1	8.8	8.0	0.6
East	13.2	7.4	5.5	10.4	7.3	2.9	21.8	8.4	12.7	[illegible]	8.1	12.2	7.8	7.4	0.4
South	12.6	8.7	3.7	6.1	7.6	-1.4	2.2	7.7	5.4	[illegible]	[illegible]	4.1	5.7	8.2	-2.5
West	13.0	7.7	5.0	9.2	7.8	1.3	14.6	7.9	6.4	[illegible]	7.6	6.5	10.2	7.5	-2.6
CPI	5.5%			1.9%			3.7%			[illegible]			4.5%		
S&P 500	14.7			18.5			5.2			[illegible]			26.4		
Corp. Bonds	17.8			19.8			-0.3			8.9			9.2		

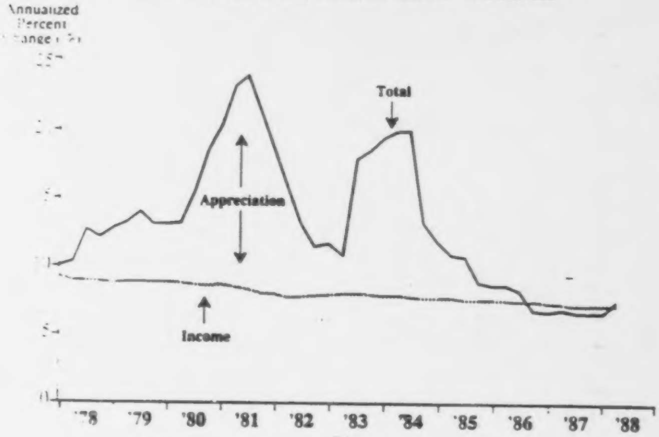
(a)Annualized

Sources: NCREIF Report, Frank Russell Co., Ibbotson and Assoc.

Investment Performance Industrial/Office – R&D

Contrary to the performance of industrial/warehouse properties, trends shown in Figure 19 indicate that Industrial/Office R&D properties continue to show subpar results relative to other investment types. Total returns in Table 15 show very mixed results, with no clear pattern or trend for any of the regions for which data are available.

Figure 19
U.S. Industrial/Office R&D Returns



Source: FRC Company.

Table 15

Industrial/Office-R&D Property Investment Returns

	1980-85			1986			1987			2Q87 to 2Q88			2Q88(a)		
	Total	Inc.	App.	Total	Inc.	App.	Total	Inc.	App.	Total	Inc.	App.	Total	Inc.	App.
National	12.7%	8.1%	8.2%	7.5%	7.8%	-0.4%	6.6%	7.4%	0.8%	7.8%	7.5%	0.2%	5.3%	7.6%	-2.4%
Midwest	10.4	8.5	1.7	10.5	8.5	2.0	5.4	7.4	2.0	[illegible]	7.3	-1.7	8.7	6.9	1.8
East	15.7	8.7	6.6	15.0	8.5	2.0	5.4	7.4	[illegible]	[illegible]	[illegible]	1.7	3.0	7.0	-3.8
South	14.3	8.5	5.4	2.0	7.8	5.1	1.2	[illegible]	[illegible]	[illegible]	[illegible]	4.2	1.1	7.3	6.1
West	21.3	7.7	12.9	7.2	7.8	0.6	6.0	[illegible]	[illegible]	[illegible]	[illegible]	0.8	6.4	7.9	1.4
CPI	5.5%			1.9%			[illegible]			[illegible]			[illegible]		
S&P 500	14.7			18.5			5.2			[illegible]			26.4		
Corp. Bonds	17.8			19.8			-0.3			[illegible]			9.2		

(a)Annualized

Sources: NCREIF Report, Frank Russell Co., Ibbotson and Assoc.

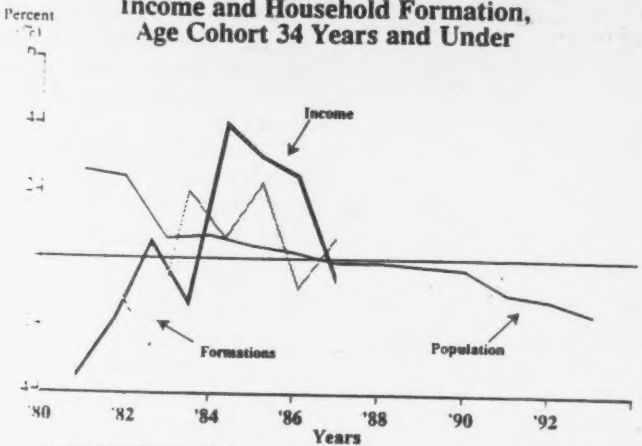
Multifamily Property Outlook

Demand Indicators

Trends in important determinants of demand for multifamily housing are shown in Figure 20. A breakdown of data relevant to those trends is contained in Table 16. The general decline in population growth in the primary age groups that rent multifamily housing units is well underway and will continue beyond the year 2000. While this trend indicates a general decline in the demand for multifamily housing, rates of household formation are also very important when analyzing this demand. If the latter were to increase, the impact of declining population on demand would be moderated to some extent. However, rates of formation in the 34 year old and under age group, as shown in the figure, have been erratic. This is because formations depend on household income, divorce rates, and other socio-economic factors, all of which are difficult to predict. While household formations do change in other age cohorts not shown in Figure 20, and indicators shown in the figure probably exaggerate the decline in demand to some extent, the direction of change appears to be downward. This is true for both population and, eventually, household formations in age groups that constitute the primary basis for multifamily housing demand.

Figure 20

Change in Population, Age Cohort 18–34, Income and Household Formation, Age Cohort 34 Years and Under



Source: Data Resources, Inc.

Table 16

Changes in Demand Indicators For Multifamily Housing

	1980–1985	1986	1987	2Q87–2Q88
a) Change in Population Aged 18–34 years and younger	0 .8	-0.1	-0.1	NA
b) Change in Household Formations Headed by Persons 34 years and younger	0 .31	-0.8	0.7	NA
c) Change in Personal Income of Households in (b)	0.9	2.5	-0.5	NA

NA – Not available

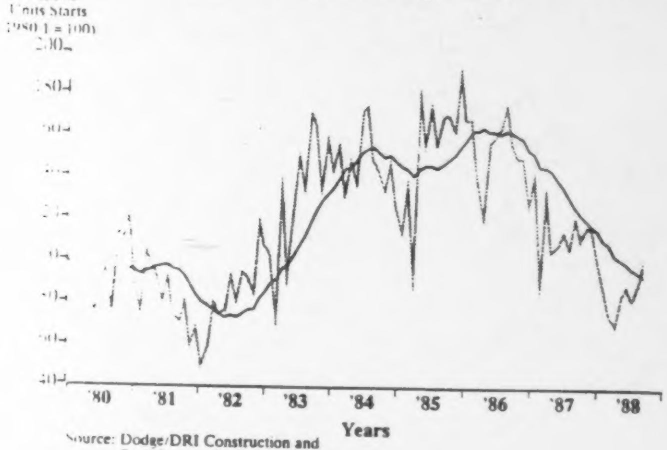
Source: Data Resources, Inc.

Supply Indicators

Changes in the supply of multifamily housing have generally declined in response to declining demand. Figure 21 shows the trend in recent changes in multifamily housing starts.

Figure 21

Multifamily Housing Starts



Source: Dodge/DRI Construction and
Real Estate Information Service.

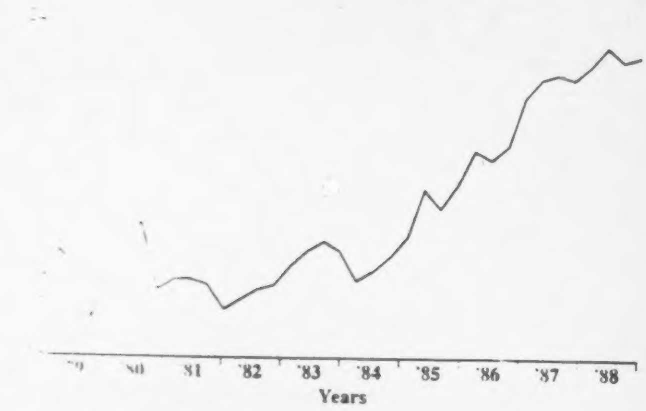
Specific data relative to starts are as follows:

	1980–1985	1986	1987	2Q87–2Q88
Change in Starts	11.1%	-10.5%	-25.2%	-5.8%

The negative trend in starts since 1986 has been significant. Regarding vacancies, Figure 22 shows that they have also increased; however, they show signs of stabilizing.

Figure 22

Multifamily Vacancy Rates



Source: National Association of Homebuilders.

Recent changes in vacancy rates compiled by the Commerce Department are as follows:

	1980–1985	1986	1987	YTD 1Q88
% Vacant	7.3%	10.3%	11.1%	11.3%

Based on the trends in household formations and vacancy rates, a further reduction in the supply of multifamily units will likely occur before the correction in this market is complete. However, historically high vacancy rates and the deteriorating demographics facing this segment make it difficult to estimate how large a reduction will be required to balance the market or how long this process will take. These trends will remain a major concern to developers and investors for some time to come.

Investment Performance

Unlike the property categories discussed this far, no investment performance indexes exist for rental apartment properties. However, one indirect measure of performance is the rent component of the CPI that is shown in Figure 23. This index gives a general indication of how rents on all types of rental housing are changing, and, when compared with the CPI,[5] gives an indication as to how rents are changing relative to the price of other goods. This comparison is as follows:

	1980–1985	1986	1987	2Q87–2Q88	2Q88
% Change Rent Component of CPI	6.0%	5.0%	4.0%	4.0%	2.8%
% Change CPI	5.5	1.9	3.7	4.0	4.5

Clearly, the trend in rental income produced by multifamily housing investments is downward, both absolutely and relative to the CPI.

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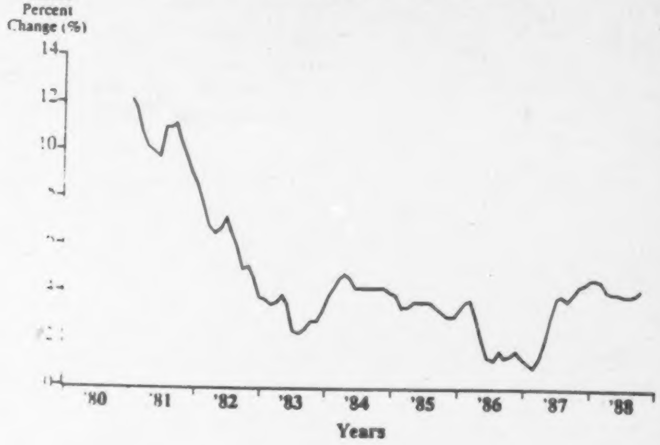
[5] Although contract rents are included in the CPI, they only comprise about 6% of the weight in the index. Hence, the comparison shown here is useful even though contract rents are contained in both.

Figure 23
The Rent Component of the CPI

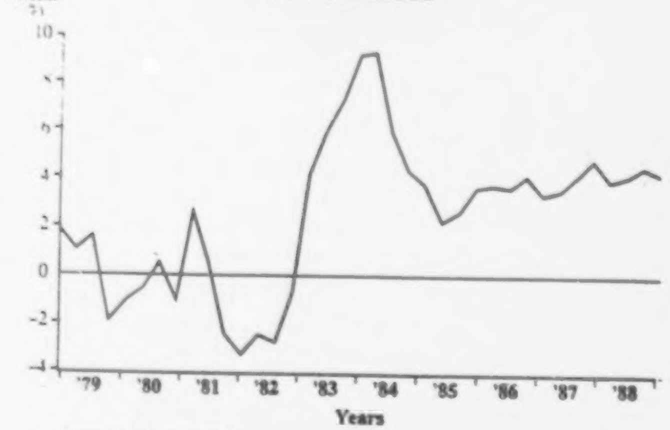


Hotel Property Outlook

Demand

An estimated two-thirds of hotel demand is business related and one-third is recreational. One indirect measure of both business and recreational demand for lodging is the Hotel Demand Index. Of this index, 10% is pretax corporate profits, 45% is real GNP, and 45% is real personal consumption expenditures. Based on this index, lodging demand appears to have increased moderately through the second quarter of 1988. Although the index has been trending upward since early 1985, its recent growth rate falls short of the impressive increases that occurred during 1983 and 1984, when the economy was emerging from a recession and heading into an expansion. This year, the index grew at an annual rate of 4% during the first quarter and 6% during the second quarter (see Figure 24).

Figure 24
Change in Goldman Sachs Hotel Demand Index



Source: Data Resources, Inc.

The substantial strengthening of foreign currencies relative to the U.S. dollar has stimulated pleasure travel to the United States from abroad while at the same time has discouraged U.S. citizens from vacationing overseas. Both of these results are positive developments for vacation-related hotel demand. The effect of exchange-rate fluctuations on business-related demand is less clear, however. The influx of foreign businessmen to the United States and the outflow of U.S. businessmen abroad, and therefore net demand for overseas versus domestic lodging, probably relate more closely to the volume of total trade than the relative magnitude of exports and imports.

Over the next several quarters, the recent drop in oil prices may boost both business and recreational lodging demand somewhat if the lower cost is passed on to the public via lower gasoline prices and airfares. However, if economic growth slows or becomes negative, then lodging demand will probably decline.

Supply

The volume of hotel starts continues to fall (see Figure 25). The less accommodative 1986 tax law, moderately increasing room rates, and generally flat occupancy rates continue to reverse the sharp increase in hotel construction that began in late 1982. A 12-month moving average of hotel starts increased 81.5% from November 1982 to July 1985. Since that peak, hotel starts have fallen 28.5%. Given the lackluster condition of the industry, hotel construction at the national level is unlikely to increase in the near future. However, some areas of the country are experiencing significant building. Through the first half of 1988, Orlando, Florida led the nation in total area of hotel starts. This MSA supported 12.4% of the total hotel square footage begun during that period. Los Angeles, ranked second, accounted for just under 8% of the new area under construction during the first half of 1988 (see Table 17).

Table 17

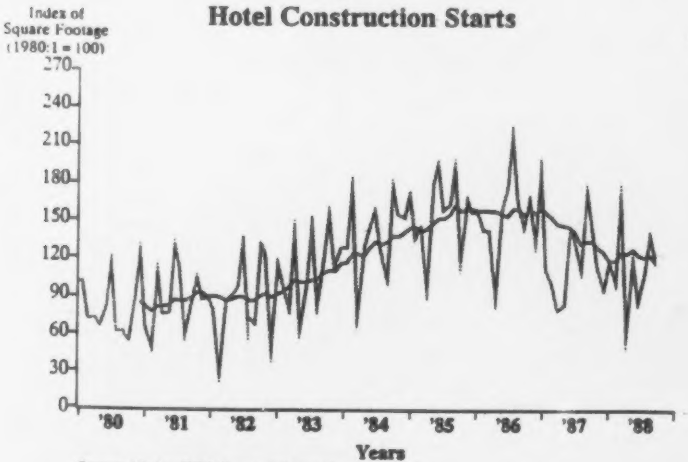
Top Ten MSAs For Hotel Construction, First-Half 1988

	% of Total
Orlando, Florida	12.4%
Los Angeles, California	7.9
Chicago, Illinois	7.8
Anaheim - Santa Ana - Garden Grove, California	6.2
New York, New York	5.6
Washington, D.C.	4.6
Seattle - Everett, Washington	4.2
San Diego, California	3.8
Detroit, Michigan	3.1
Atlanta, Georgia	3.0

Sources: Dodge/DRI Construction and Real Estate Information Service.

Figure 25

Hotel Construction Starts



Source: Dodge/DRI Construction and Real Estate Information Service.

Vacancy

U.S. hotel occupancy rates through May 1988 have remained essentially unchanged from 1987 levels, averaging 66.1% versus 66.5%. Western occupancy rates are somewhat lower than a year earlier, while rates in the South, North East, and North Central regions are similar to levels reached in 1987. Areas of strength in an otherwise lackluster industry include hotels located in the Mid-Atlantic Census Division and resort properties. Year-to-date, resorts have averaged occupancies of 72.5% and hotels in the Middle Atlantic region 71.5%, both considerably higher than the national average (see Table 18).

Table 18

Year–to–Date Regional Hotel Occupancy Rates (a)

Region	1987	1988
Northeast	68.9	68.8
New England	60.5	61.1
Middle Atlantic	71.7	71.5
North Central	58.3	57.8
East North Central	60.0	59.9
West North Central	55.2	54.0
South Central	67.4	67.5
East South Central	52.6	56.1
South Atlantic	72.8	71.6
West South Central	56.3	59.0
West	67.2	64.5
Mountain	61.0	59.2
Pacific	70.2	68.0
U.S. Total	**66.5**	**66.1**

(a) The Geographic regions are as follows:
Census Region:

Zone	Census Divisions Included
Northeast	New England, Middle Atlantic
North Central	East North Central, West North Central
South	East South Central, South Atlantic, West South Central
West	Mountain, Pacific

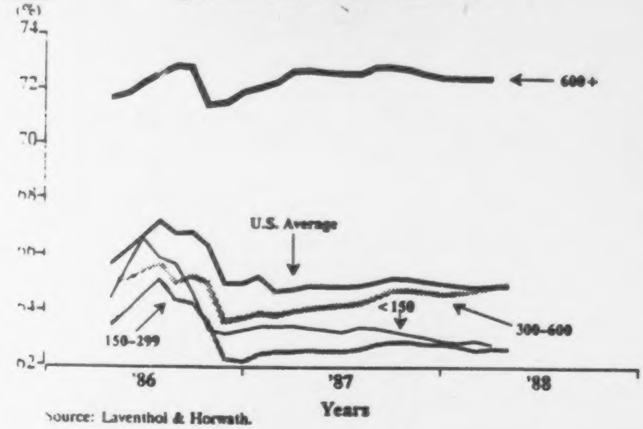
Census Division:

New England	CT, ME, MA, NH, RI, VT
Middle Atlantic	NJ, NY, PA
South Atlantic	DC, DE, FL, GA, MD, SC, VA, WV
East North Central	IL, IN, MI, OH, WI
East South Central	AL, MS, TN
West North Central	IA, KS, MN, MO, ND, NE, SD
West South Central	AR, KY, LA, OK, TX
Mountain	AZ, CO, ID, MT, NV, NM, UT, WY
Pacific	AK, CA, HI, OR, WA

Source: Laventhol & Horwath.

Generally, size and occupancy rates of hotels seem to be positively correlated. Figure 26 shows that hotel properties with fewer than 300 rooms have occupancy rates considerably below the national average, while hotels with 600 or more rooms have occupancy rates significantly higher than the national average. In the past, hotel properties with between 300 and 600 rooms have had slightly lower-than-average occupancy levels, although over the last year, their occupancy rates have increased and now slightly exceed the U.S. average. Several possible explanations exist for the dominance of larger over smaller hotels. Large hotels are often members of national hospitality companies or chains. In many instances, this affiliation, coupled with economies of scale, give these properties a competitive advantage over their smaller, independently-owned counterparts. National hotel companies enjoy advantages in quantity purchasing arrangements. Also, major lodging chains benefit from brand awareness that does not require the traveler to judge both the price and quality of the hotel before booking the room. Making reservations is facilitated by the extensive computer systems used by these chains. Many small hotels do not enjoy these advantages. Also, smaller properties are unable to host conventions, an important component of lodging revenue for many companies.

Figure 26
Hotel Occupancy Rates
by Number of Hotel Rooms



Source: Laventhol & Horwath.

Performance

Average national room rates, while growing, are not outpacing inflation. From May 1987 to May 1988 room rates increased 3.1%, while the consumer price index rose 3.9% during the same period. This lackluster growth is partially due to the large increase in the supply of space that occurred during the early to mid-1980's. However, the increasing development of lower priced and economy-type lodging may also be lowering the average daily room rate. As it did in 1987, the Northeast continues to support the highest room rates relative to other regions and the Middle Atlantic still has the highest room rates within that region and compared to all other regions (see Table 19).

Table 19

Year-To-Date Room Sales Per Occupied Room

Region	1987	1988
Northeast	$102.27	$107.59
New England	77.63	79.51
Middle Atlantic	109.07	115.69
North Central	53.91	55.86
East North Central	55.53	58.00
West North Central	50.78	51.67
South Central	66.12	67.38
East South Central	45.15	44.81
South Atlantic	70.59	72.07
West South Central	54.57	55.59
West	67.52	69.45
Mountain	57.31	59.10
Pacific	71.74	73.26
U.S. Total	**70.30**	**72.26**

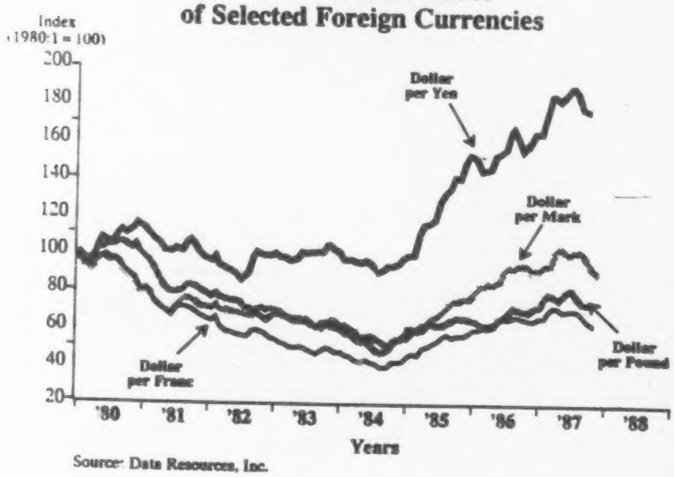
Source: Laventhol & Horwath.

Foreign Investment And U.S. Real Estate - The Current Climate

Overview

International financial markets will continue to have an important influence on U.S. real estate markets. This observation is based on current patterns in exchange rates and interest rate spreads between U.S. and traditionally significant trading partners. Figure 27 shows that while the dollar has generally strengthened somewhat relative to other currencies (U.K., West Germany and Japan) during the past two quarters, the rate of exchange of each currency relative to the dollar remains high by historical standards. This suggests that the current improvement in exports from the U.S. is likely to continue, at least for the short run. As already noted, industrial warehouses in port cities are likely to be direct beneficiaries of this export activity.

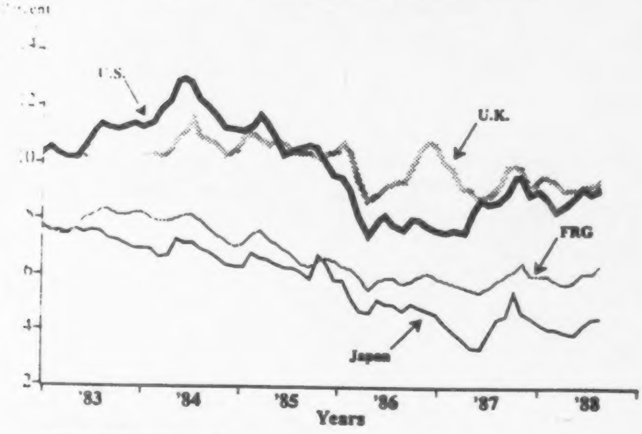
Figure 27
Indexed Dollar Values
of Selected Foreign Currencies



Source: Data Resources, Inc.

As for foreign funds flow, Figure 28 shows the relationship between U.S. long term government bond yields (ten-year maturities) and similar yields on government bonds in the U.K., West Germany and Japan. Differentials are greatest between U.S. yields and those of Japan and West Germany, suggesting that an inflow of longer term investment capital is likely to continue from those sources. Much of these flows should take the form of direct purchases of properties as well as provide a source for mortgage credit (a trend already noted in Table 3).

Figure 28
Long Term Government Bond Rates



Source: Data Resources, Inc.

✓

BENTON
INTERNATIONAL

January 18, 1989

Mr. M. Danny Wall
Chairman
Federal Home Loan Bank Board
1700 G Street, N.W.
5th Floor
Washington, D.C. 20552

Dear Mr. Chairman:

Several weeks before Christmas you invited me to examine the structure and potential of the Southwest Plan. You asked me to focus specifically on the incentive structure, the consolidation objectives, the marketing of real estate assets, and the fairness of the deals. You also urged me to consider anything else that I thought might be important.

This is my report.

PROCESS

You asked three other people to make a similar examination, two from the savings and loan industry and one from the real estate industry. As you know, I represent yet a third category, an owner/executive of an international management consulting company, which works extensively not only with financial institutions, but also with computer, telecommunications, and retail organizations.

The following approach was taken to this task. Initially, I discussed the issues with your staff over the telephone, studied several Assistance Agreements, visited the supervisory staff in Dallas, Texas, and discussed the issues at length with your three other principal advisors, individually and collectively.

Against this background, I then developed a set of hypotheses, which I tested in conversations with a number of persons (including other members of the Advisory Committee), and documented in a rather long letter which I sent to you.

Since submitting that letter, I have done the following:

- Read the minutes of last year's meetings of the Southwest Advisory Committee, in Dallas.

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747 Third Ave. / 26th Floor / New York N.Y. 10017 / (212) 752-3020

- Conducted an intensive two-day investigation in Washington, meeting with your senior management, your General Counsel, Dr. Larry White, and of course yourself. My perspective and my understanding of the issues were greatly aided by the presence of Messrs. Borshoff, Schmidt, and Ballard at a number of these meetings.

- Returned to Dallas and conducted a dinner meeting and an all-day session with about a dozen people from both your Dallas Bank and Washington, the objective being to examine in depth the principles and management style involved in consolidating the merged entities.

- Met for two hours with the Southwest Advisory Committee in Dallas, Texas.

- Read discussion memos from Mr. John Henry, Outside Counsel working with OGC, which described various uncertainties in the structure of the current Assistance Agreements.

Throughout this process, I have of course consulted with my associates at Benton International, Inc. Additionally, I have sought other assistance to help me understand the tax implications of the deals, and I have spoken informally with personal contacts in Texas who have a first-hand knowledge of the Assistance Agreements.

You will understand that, given the short time frame, I approach this letter with a certain cautiousness. I do not know the details of every deal. I do not understand every use or stimulus of the tax structure. I have had only limited conversation with the key participants, who surely could have provided me more detail, given more time.

On the other hand, you also know that I have the background necessary to get to the heart of these issues pretty quickly. I have run a congressionally established, presidentially appointed study commission on public policy issues in all aspects of electronic banking, and, of course, I started and developed a respected international business that has undertaken assignments with most of the major financial institutions of our country. This experience, plus a good deal of work at places like Rand, has prepared me to see the business dynamics. Moreover, having obtained a Doctorate in Public Administration, I have nurtured a lifetime interest in and commitment to the principles of the public sector. This rather unusual background prompts me to offer what I hope will be a useful insight or two.

THE ENVIRONMENT

Even a casual look validates the enormousness of the problem. You are dealing with a type of financial disaster not seen in decades. Given your appointment in the middle of 1987, it clearly did not develop on your watch. Indeed, I for one cannot help but feel intense anger that at the core of this problem is a catastrophic breakdown in business ethics. Perhaps you also have some of these feelings. This breakdown occurred everywhere–among developers, bankers, regulators, and elected officials. Arguments that regulators failed to regulate or that new powers led some people astray may have some merit. It is also true that well-meaning business people might have run into bad luck or stretched beyond their competence. But at the core, only a fundamental breakdown in business ethics could have caused a problem this large.

But what do you do now? I would suggest that interested parties turn their attention first to damage control and then to historical analysis. What has happened is done, and cannot be repaired.

My starting point, therefore, is how to help you control the damage. The benefits of your program, I think, should be focused first upon minimizing the damage to the tax-paying public, and, only second, on protecting the thrift industry. I neither assume nor comment on the continued existence or elimination of the savings and loan industry. My focus is exclusively on reducing to a practical minimum, over whatever period of time required, the cost of this crisis to the nation.

Of course, this cost is already enormous and will eventually become much larger than any actual expenditures or irrevocable financial commitments made thus far. However, as it relates to the Southwest Plan, the absolute size of the problem is not the issue. The point now is to make sure that the crisis is effectively managed, so that in the end the solution ends up costing perhaps 20% to 30% less than it will otherwise. In my opinion, you are fighting to save the nation $10 to $20 billion, a savings which can be drawn from the quality of the management of the problem from this point forward.

FIVE OPTIONS

I commend you and your staff for concluding that the hemorrhaging had to stop. I agree that the two most obvious options had to be rejected, namely, permitting the owners of the distressed institutions to continue to control the management or taking these institutions into long-term FSLIC receivership. In part, my reasoning is this:

- The pressure on distressed managers seems to compel them to increase their risks because they want to fight their way out of the problem and they come under the sway of a psychology to look for the "big pop," the deal that is going to make up for all the bad deals. Bad judgment breeds bad judgment. For whatever the reason–bad luck, incompetence, greed–management has lost. These institutions, as some pundits have it, are brain dead. A different team is usually needed to work out the problem.

- A government receivership is likely to breed inaction. (Indeed, this is one of the risks even of the current program, a risk which is discussed below.) It is only natural for a receiver to be highly cautious and risk adverse, whereas rigorous, creative, proactive management is going to be needed to minimize the damage.

> Given tradition, current guidelines, and constant heat from the outside, this probably cannot be obtained from a government receivership.

I believe that you faced three other options–liquidating these institutions, organizing conventional mergers, or performing the assisted mergers that are the instrument of the Southwest Plan.

The Liquidation Issue

The argument has been made that you should have liquidated the distressed institutions. In part, your defense for not doing so has rested on the out-of-pocket cash required to liquidate or to fund the reorganization.

Beyond this defense, I reject the liquidation option because it is far too general an approach to a very complex problem. First, one must define what should be liquidated. In this regard, I am assured that your staff has already decided to embark on a selective liquidation strategy. I am assured by Mr. Root that you intend to move very aggressively in this direction and that you are going to identify and remove the very worst assets, and to redeem the liabilities standing behind those assets.

However, it would be inefficient and wasteful to apply a liquidation strategy across the board, and, therefore, I unequivocally support your rejection of this option. Having been personally involved in highly stressed businesses during the past decade, I have learned a very useful lesson. At times it is critically important to make time your ally, not your enemy. Yes, the Texas problem is primarily one of bad management. But it is also a problem of markets. Markets respond unpredictably to a complex array of factors within an uncontrollable time frame. In the final analysis, a problem with legitimate real estate assets–finished construction and habitable properties–is partially a problem with time.

Of course, as your critics have pointed out, both good and bad things can happen over time. In my opinion, however, you are not simply trading one time period for another in the Southwest Plan. The course you are taking here should have a net advantage, because you have:

- Reduced the stress of the management challenge. Your acquirers face a normal, though most difficult, set of challenges. Given the protections of the Southwest Plan, there is no reason for the new management to be lying awake at 2:23 a.m., day after day, month after month, in a state of physiological wreck and mental depression, trying to work out solutions for problems that are intractable in the short run. Having provided for this change in management psychology is potentially a great advantage.

- The acquirers have a greatly expanded set of weapons–the yield subsidies, the protection against capital loss, and the considerable advice, counsel, and oversight of your staff and your contractors. They should be able to move prudently to maintain (or expeditiously to sell) the covered assets under their management, given the appropriate circumstances.

- The Southwest Plan will expand creativity. The acquirers are not alone. They will learn from each other. Some acquirers will bring valuable different disciplines and financial skills to the problem. I think that your critics' concern about whether the acquirers have a long-term commitment to a savings and loan franchise will usually prove to be irrelevant to the catastrophe at hand.

  The Southwest Plan is not only about protecting the savings and loan industry. The most important mission is to reduce, to the absolute minimum, the net loss that the country must pay for the failure of the Southwest savings and loan industry. The plan will depend upon creative management, a gradual liquidation of assets, and a reorganization that results in the most optimal operating performance. Success will require different types of disciplines, especially some of those which are found outside of banking. The strategic objectives of your program will not have been missed if, when the clean-up is accomplished, acquirers should decide to sell off the remaining "good banks" which emerge from the work-out programs.

- The effective management of time has worked before. It worked for Chrysler. It worked for Lockeed. It also worked for financial institutions like Continental Bank. It appears to be the approach that the United States has adopted for the foreign debt situation.

Consequently, I reject the option that insolvent institutions in the Southwest should simply be liquidated. The Southwest program should achieve a much smaller net loss than the liquidation option.

Conventional Mergers

I do not think that the option of conventional merger is available.

Conventional mergers, even partially assisted mergers, are painful and highly risky undertakings. Even when substantial due diligence precedes the merger, there can be major surprises in an environment like Texas. Both First Interstate of California and, I gather, Chemical Bank have had major surprises with their Texas acquisitions.

Texas presents an especially uncertain environment for the acquisition of a distressed institution.

I believe that well-qualified acquirers are unwilling to take unassisted business risks in Texas.

Assisted Mergers

It is my conviction that assisted mergers of the type being done under the Southwest Plan are an absolute necessity.

It is my judgment that the pricing and the terms and conditions are dominating these deals, and that therefore, they are about as good as you could get, given the time frame and the incomplete and imperfect knowledge of value.

On the other hand, my experience and evaluation suggest that the FHLBB is probably a more conservative deal-maker than most private companies. Indeed, the real risk might be that the deals are too conservative and, therefore, only of interest to a more speculative type of acquirer. Let us look more closely at these deals.

THE DEALS

Essentially, I believe that there was inadequate demand to buy Texas savings and loans, under any sort of normal risk/reward formula.

In the original Southwest concept, it was not essential that there be a significant equity contribution. Thus, the earlier deals were not as equity rich as the deals occurring in the last quarter of 1988. At the same time, the earlier deals were not rich in tax benefits, with most of the benefits reverting to the Government. In the more recent deals, as equity requirements grew, so did the demand for more tax benefits. In short, the "price" did not change, only the terms and conditions.

That is to say, tax sheltering must simply be viewed as part of the pricing algorithm. In fact, the tax sheltering issue may be more a matter of the re-distribution of resources between and among the agencies of the Federal Government than an issue of re-distribution between the private and the public sector.

In my judgment, the initial accomplishment of the Southwest deals was to make a fundamental change in the ownership and management team with which FSLIC must work, truly as a partner, for many years to come. These deals do not constitute a transfer of risk from the government (and hence the public) to private business people. No good deal accomplishes that end. Good deals do not redistribute risk. They redistribute opportunity. They change the circumstances. As an economist would say, they move the distribution of challenge and opportunity from one "preference function" to another. As a business person might say, they reassign the challenges and opportunities to create a better fit between skill and resources and the challenges at hand.

Yes, you have raised over $1 billion in capital, but this has been counterbalanced by the value of the "good bank" imbedded in every deal and the tax sheltering. Yes, you have brought in a new real estate work-out team, but this is counterbalanced by the yield subsidies which provide sufficient gross margin to fund a fairly active real estate work-out program. Yes, you have transferred highly distressed assets to new hands in the private sector, but this is countered by your willingness to stand behind losses and even surprise adjustments across the whole range of assets for some years to come. Yes, you have transferred distressed insolvent companies to new ownership, en masse, but you have given the new managements a level playing field by injecting capital or capital equivalents to make the acquisitions solvent. Yes, there is some risk in these deals for the new owners after they have been in command for several years, but there is almost no risk for the new owners for the first several years, giving them substantial breathing space to chart out a winning strategy. These are the reasons why I view the Southwest Plan as a management strategy rather than as a divestiture program.

As I noted in the beginning of this letter, I have not examined every aspect of the deals. I am therefore making some assumptions. For example, I am assuming that the relevant issue is not the absolute size of a net operating loss carry forward, but rather, how the acquirer is permitted in law to use it. I am assuming that most N.O.L.'s will apply against savings and loan industry profits, and also that they will be worked off over a number of years. I am assuming that there are restrictions regarding the upstreaming of N.O.L.'s into non-banking businesses. I am assuming that recapture provisions would discourage imprudent use of tax benefits to overstate current year income. I am further aware that, in almost all cases, a substantial amount of the tax benefits, over 75% in the early deals and less in the December deals, reverted back to the Government. If so, it seems clear that you have made and are making responsible use of the tax laws, that all benefits were calculated by you when establishing the price of the deals, and that the real interpretation of the use of tax benefits is in regard to terms and conditions.

In short, you have done "deals." You have made trade-offs--for instance, tax breaks for equity. You are selling insolvent institutions. You have injected capital to bring them up to zero net worth. Therefore, you are still selling very little. Moreover, no one believes that the valuation of the assets is correct. Otherwise, you would not be agreeing to deals which benchmark assets at 80% of book value, or in some cases, 50%. Moreover, some of your uncovered assets are also worth much less than book, but are carried at book because the loans, notwithstanding true value, are still being serviced. In fact, therefore, your own deals suggest that the acquired institutions are weaker than the numbers would suggest.

It is my opinion that there are no easy, risk-free windfalls in these deals. On day one, you have transferred very little of value, and probably received very little of value. You have become a joint venture partner in a deal designed to grow a business from nothing to something. As in all new business, the future is at least partly in your hands. The FHLBB has achieved the start position.

The race is yet to be run. Your own initiative, determination, proactive leadership, and courage will help determine the outcome. Not the deals!

I believe that these words apply equally well to your partners. Yes, there will be luck, and someone might make excess profits. There will also be bad luck. Otherwise, your acquirers will make it, or lose, based upon their creativity, their courage, and their determination–just like you.

In the final analysis, the country should hope that most of your acquirers make out very well, because their success as the managers of your program will determine your success.

There is one way the country can lose, and lose big. This outcome could occur if the FHLBB adopted a position that the structure of the deals will determine the outcome. This unfortunate position could be adopted if a belief develops that these deals represent a fiscal type of economic intervention, grounded on the belief that the unguided hand of economic forces will dominate the final outcome. In my judgment, the structure will influence the outcome, but it will not dominate it. The outcome will be dominated by management.

If the acquirers are the dominant management force, they will disproportionately influence the outcome, and perhaps in a fashion that will defeat public purpose. If the FHLBB and its affiliates have equal power with the new management, public policy and private entrepreneuralism will split the rewards, as all good deals split the rewards, and you will accomplish your policy mission. In other words, it is my dominant feeling that, alone, these deals will not accomplish the policy outcome that the country must have. Consequently, I will be discussing below a wide range of management actions that I think are absolutely vital for the success of this program, and which I believe are essentially permitted in your written contracts.

At the same time, I am stating as unequivocally as I can that the structure of these deals is more than sufficient, and fair, and protective of the interests of the public to accomplish effectively the purposes behind the plan.

ASSET SEGMENTATION

Earlier, I mentioned the removal of junk assets. I believe that this benefits both the acquirers and the Government. Now I raise the issue of assets which are not true junk–the buildings that are built and habitable–but which represent unmistakable failures of business as practiced by the private sector.

I believe that there is such a category of assets. These are the assets that may be in a negative cash position for as long as ten to fifteen years.

I believe that these assets can be separated from both the junk and from the assets which should be cash positive within three to seven years. I believe that this separation can be made with about an 80% level of confidence, i.e., not more than 20% of what you put in the package, and perhaps much less, will be mis-categorized.

I think that these assets should be identified and, in effect, nationalized by putting them into some type of an Asset Holding Company. [redacted] All holding costs would be paid back to the government through positive rent streams paid many years into the future and through eventual liquidation of the properties in the late 1990's or early 2000's. Assuming a reasonable average annual rate of inflation, from now until then, the net cost to the country may be less than keeping these assets under the Southwest Plan structure.

I do not believe that the government should be paying yield subsidies for long-term property management when there is no hope of disposal consistent with private sector models.

LONG-TERM IMPLEMENTATION OF THE SOUTHWEST PLAN

In the final analysis, the FHLBB is going to adopt one of two courses of action. First, it may execute the Assistance Agreements, permit the legal/economic provisions of these agreements to work, and revert to its role as a regulator/evaluator. Second, it may execute the Assistance Agreements, put in place the appropriate legal/economic conditions, and adopt a new role as an activist/partner in each of these deals. The difference between these two approaches is that the first assumes that, through regulation alone, the FSLIC can get the acquirers to do smart things. The second assumes that it cannot, that it can only lead a partner to do smart things. The choice is between being an evaluator and being a leader, a choice between being an auditor and being a division manager. In the end, these choices are spiritual and cultural, having very little to do with either organizational design or legal framework. My fear is that this subtlety is going to be missed.

The FSLIC must share equally with the acquirers for the long-term success of this program. The government is the venture capitalist. The government is the party at enormous economic risk. The government must participate in the active management of these organizations. Below I will recommend specific steps which illustrate the meaning behind these words.

The Assistance Agreements have reorganized the industry, led to strengthening of its management capabilities, stimulated the investing of new capital, and eliminated day-to-day management stress in order to permit calmer, more creative effort to be placed against the problem.

However, these agreements represent a plan, not a software system. The latter will behave as precisely instructed. Not so, the former. They will now be subjected to every conceivable force:

BEST AVAILABLE COPY

- Diversion of attention because of other business interests.
- The unintended impacts of the current incentive structure.
- A bias toward conservatism and risk aversion.
- Lack of knowledge and experience to implement.
- The unknown influences of self-interest.
- Regulatory conservatism and bureaucratic caution.

In my judgment, if the FHLBB follows the regulator model, you can expect three outcomes:

1. Some of these deal will look terrible five years from now, either because the government will, indeed, have provided windfall profits in exchange for very little or because certain acquirers will be wiped out, sending the problem back to FSLIC, but now at a much greater cost.
2. Some of these deals will receive a satisfactory review, in spite of the fact that they did not work.
3. Some of these deals will be very successful.

It is my considered belief that if FSLIC adopts a very strong management philosophy it will prevent most if not all of the potential damage from the first outcome.

I quote the words of your advisors spoken at the meeting I attended in Dallas with the Southwest Planning Group:

- "FSLIC must take an entrepreneurial interest in the execution of these deals."
- "Serious involvement by FSLIC cannot regulate you to do smart things."
- "FSLIC must take a very active role to make sure that people are meeting their business plans."

I think these comments are important because they are coming from industry people and public interest people who, presumably, are very sensitive about FSLIC stepping across the line separating the public and private sectors.

SPECIFIC ACTION

In view of the preceding, I would make the following strategic observations and recommendations:

- Yield subsidies against hopeless assets must be provided, but only for the shortest period of time. Otherwise, an unnecessary subsidy will be granted to the acquirers. Junk assets should be disposed of and long-term investment assets should be taken back from the acquirers and held elsewhere.

- FSLIC must define as quickly as possible a set of principles and guidelines regarding the holding or the selling of covered assets. These principles and guidelines must be related to at least three or four segments of assets, based on their quality, because they will be very different depending upon which segment is being examined. (Asset segmentation, which was alluded to earlier, was discussed with you in my December memorandum.)

- FSLIC must spend whatever energy and expense is required to segment the total stock of assets contained in the Southwest Plan. (I understand that some of this work is underway.)

- The incentive structure for the deals must be augmented. An incentive/penalty schedule must be designed which mandates that some percentage of the stock, in each segment, be sold per year. The percentage so defined would lose its yield subsidy at the end of the year, without consideration to the formula decline in yield subsidy which is already agreed to in the contracts.

  As only an illustration, assuming a ten-year plan and averaging across all segments, the target might be to move 5% of the stock in the first twelve months, 10% in the second, 12% for each of the next four years, and an even apportionment of the remainder over the last four years.

- If it is to serve as a true partner, FSLIC must give much more thought to consolidation strategy and tactics.

  When FSLIC completes this restructuring process, it will have implicitly rearchitected the retail banking delivery system for the Texas savings and loan industry. Exactly what system will have been created? Exactly how will it function? Without an explicit set of goals and an explicit plan, this changed system may in fact become a barrier to achieving the aims of the restructuring process itself.

  Let me explain. The assisted thrifts will struggle to pare the branch system, trim and centralize the home office staff, and reduce other non-interest expenses. If they are successful, they will surely cut costs. (However, the consolidation goals just listed are, themselves, no easy task.) Unfortunately, these moves might nevertheless tie the institutions to an inefficient, totally branch-dependent delivery system which locks them into a long-term competitive disadvantage. The inevitable result would be a loss of market share for liability-based products, forcing an increase in the cost of funds, which is precisely the opposite result of what you must have.

The threat behind this concern is competition. Competitors (not involved with the Southwest Plan) could enter the market with much more flexible and efficient channels of product distribution, for both selling products and for providing essential customer service support. Specifically, the competition:

- Might rely much less on the branch as the major channel of product sales and service distribution.
- Might make greater use of ATM's and POS for cash acquisition.
- Might use telemarketing as a substitute for branch originated selling.
- Might use specialized and streamlined loan origination offices.
- Might make use of 24-hour customer service hot lines.
- Might make use of modernized branches which emphasize advanced retailing techniques.
- Might have a much more integrated operations and data processing back end.

In essence, the Southwest Plan execution will implicitly define retail banking delivery strategy, whether or not it intends to. I strongly urge you to make this explicit. I recommend that you immediately undertake a study which could help expand the Home Loan Bank System's knowledge of this matter, especially the economic benefits of a systematic and explicit rearchitecture and the competitive threat if the rearchitecture is permitted to happen on its own.

I further recommend that the FHLBB move tactically in several directions:

1. Set up a loosely defined technology and distribution system user group, made up of all assisted institutions, which could focus on issues and alternatives essential for survival in this area of competitive threat. This group could fund some strategic investigation, but it could also think through how it might cooperate in such areas as the following:

- Establishing a shared 24-hour customer service center.
- Joint contracting for third party servicing.
- Joint purchasing of computer and data communications equipment and of network services.
- Joint purchasing of software.
- Joint purchasing of consulting services.

2. Take a rigorous look now at the opportunities presented to FSLIC through its 50.1% ownership of Affiliated Computer Systems, which was obtained when FSLIC took over Gibraltar Savings Association. Does ownership automatically go to the Pearlman people? If not, does the management of ACS have the right to buy FSLIC's stock in ACS? If not, FSLIC might have some very interesting opportunities. In five years time, its share of ACS will probably be worth $250- $300 million. Of equal importance, FSLIC could dedicate that third party processor, in some way, toward the acquirers. That is, it could create some kind of a processing package for the assisted institutions.

3. In the years ahead, you must closely oversee all consolidation/execution. I would recommend that FHLBB develop:

   - Standardized project management tools.
   - Standardized methods for monitoring progress.
   - A centralized tracking system.

4. In particular, FHLBB must provide on-site, in-depth evaluation of consolidation projects. If I have another favorite phrase after twelve years of involvement with retail banking distribution systems it is this: The devil is in the detail! Plans are just documents. Your people must look beyond the plans, and they must know what to look for. And they must do this regularly.

   - FHLBB must provide an interface over to the technology and distribution systems user group.
   - FHLBB might consider helping in the shared purchase of data processing services.
   - FHLBB might consider helping provide consulting and or training assistance, as needed.

5. I recommend that you set up a permanent Southwest Plan Project Office. This means:

   - Matrix the implementation program for the Southwest Plan. Use the functional bureaucracy to perform its traditional role. Use a program office to manage the non-regulatory, "partnership" side of the Southwest Plan.

   - Hire a general manager for this office. This requires not the values of a lawyer but those of a CEO.

   - Staff the office with a very small and elite tiger team.

   - Immediately design the program management strategy for:

     - asset segmentation

     - junk asset identification and removal

     - identification, scheduling, and selling of covered assets

     - definition and implementation of the sales approval process for covered assets

     - consolidation/integration management.

   - At the same time, begin to design a new program for the insolvent banks which are not under Assistance contracts. (The Southwest Planning Committee has some interesting ideas about how to handle what remains.)

   Use the functional bureaucracy for conventional supervision and assure that all major policy gets a buy off from both the functional bureaucracy and the program management office.

6. Define the career path, if necessary, for the general manager and for the tiger team members. If this proves impossible to do, FHLBB may have to consider contracting out the program office.

7. With regard to the Asset Holding Corporation, do a detailed economic and cash analysis of this concept. If it survives the study, implement it. Hire the private sector as FHLBB's property manager. Assure that there is local management in this area. Be very careful about using governmental institutions to sell real estate. Some have strongly argued that the government, working with very large blocks of assets, can seriously distort and damage local markets. Real estate liquidation

requires finesse. As Mr. Claud Ballard said, "It would be a disaster to put it all on the market. It would be almost as bad to put none of it on the market."

Incidentally, the management of the real estate could conceivably stay with the acquirers who held the assets as defined in the Assistance Agreements. In this way, they would continue to have an opportunity to earn fees and commissions, but they would cease to get yield subsidies or to have an ownership position in the assets. If the acquirers are not the right people to be property managers, the management could be bid out to major property management firms.

CONCLUSION

The preceding concludes my substantive report. I am supporting the Southwest Plan, given the qualifications stated herein. I know you recognize that your job has only started. The problem is too complex for the structure to do it alone. Regulation, oversight, and supervision are no substitute for active management. Essentially, these assets have been nationalized, and for sound reason. It is the government's responsibility to lead, to make sure that this program succeeds without excess windfalls or government caused pain for the acquirer side.

It is easy for me or anyone to recommend continued active involvement. It is harder to recommend explicit action. I have done the latter in the hope that it stimulates creative thinking about how this could be done. Frankly, I think that the action steps are obvious, and that the real challenge will be with the organizational culture of the FHLBB and its willingness to take on a more activist role, and to convince the Congress that FHLBB really has no other alternative. Watching you take the heat these past two weeks has given me the courage to also expose myself to some criticism.

I hope there is some value in these remarks and recommendations.

I wish you and your colleagues Godspeed in this truly awesome challenge. I appreciate greatly the opportunity you have already given me, and I would be pleased to stay involved if I can be of any further service.

Yours very truly

John B. Benton
President

/ym

Great American
First Savings Bank

600 B Street • San Diego, California 92183 • Telephone (619) 231-6005

JAMES C. SCHMIDT
Vice Chairman of The Board

February 24, 1989

The Honorable M. Danny Wall, Chairman
The Honorable Roger Martin, Board Member
The Honorable Lawrence White, Board Member
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

Dear Mr. Chairman and Board Members:

Enclosed is my report on the Southwest Plan. I elected to emphasize the adverse impact of real estate tax law changes upon the FSLIC since others were handling more of the operational issues.

It was a pleasure to assist you again. I'm sorry my wife's foot operation kept me from a week of interviews in Texas with Tom Borshoff. I'm ready to provide some more help, particularly to help streamline the approval process on sales of real estate. Attention in that area is crucial to the ultimate success of the Southwest Plan.

Sincerely,

Jim

James C. Schmidt

JCS:sg

Enclosure

cc: Jim Boland
Mary Creedon
Frank Haas

~~CC: FL/JL~~

REPORT TO THE FEDERAL HOME LOAN BANK

ON THE SOUTHWEST PLAN

By

James C. Schmidt
Vice Chairman
Great American First Savings Bank
San Diego, California

February 24, 1989

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GENERAL COMMENTS AND OBSERVATIONS

This is our second assignment for the FHLBB/FSLIC. The first was as part of a team along with Robert O'Brien and Stuart Root almost full time for six weeks in the summer of 1987 to give recommendations on FSLIC operations. While our individual assignment at that time was to do a report on the Management Consignment Program (MCP), the three of us were able to brainstorm and compare notes. There was a great dialogue which allowed us to help each other in coming to conclusions to be presented to the FHLBB.

That six-week assignment was completed in quite a different atmosphere than the current study as the FSLIC activities have dramatically escalated, particularly in the last quarter of 1988. Because of the constraints of the holidays it was difficult for our current group to meet together. This, in addition to the writer's wife having an operation, made it impossible for the writer to participate in a significant week of discussions in the state of Texas in January. There were limited opportunities to have continual dialogue with the other members of this consulting team as to some of the aspects of the Southwest Plan or to compare notes on various FSLIC deals. At the same time, in addition to reviewing a great deal of documentation, this writer extensively interviewed FSLIC staff and consultants as well as having discussions with institutional participants in the Southwest Plan.

The shift to FDIC management alters and shortens the assignment and also caused the writer to concentrate a major emphasis on the tax issues while some other members of the team concentrated more on operational issues. It is believed that the suggestions, particularly the tax proposals, could assist the FDIC. The report, therefore, presents suggestions for the FDIC as well as FSLIC.

It was a pleasure to work closely for a number of days both in December and early January primarily with Tom Borshoff of First Federal of Rochester. His associate, Peter Sear, joined us for another round of interviews. A review of the draft of Mr. Borshoff's report indicates that he has done an outstanding job in addressing some of the major issues. Discussions with other members of the review team were also good, though limited.

One of the important items to consider concerning the Southwest Plan is the fact that the overall concept was developed under a theory that it is better to complete transactions and put problem assets in the hands of the private sector than to liquidate assets with a government agency such as the FSLIC handling all the liquidation activity. It certainly is much cheaper to avoid liquidations and the writer thoroughly concurs with that approach.

The handling of asset disposition in a "going business" environment is much more conducive to successful disposition of problem assets. The experience of the writer and his institution, Great American, in managing three MCPs and one conservatorship for FSLIC in recent years has demonstrated to us the superiority of "going business" asset disposition process over government liquidation.

One of the advantages of a "going business" asset disposition approach is the ability and the inclination to make loans to facilitate the sales of foreclosed real estate. Seller financing is available and can be attractive, although the "at risk" tax rules which are discussed later in this report have, since 1986, created a partial impediment to this approach.

The Southwest Plan transactions were put in place while FSLIC was facing a 12/31/88 deadline as to the expiration of certain tax benefits. This deadline created a rush to utilize all of the legally permissible tax benefits that were in place for the benefit of acquirors and/or FSLIC prior to year-end 1988. If it had not been necessary to rush these transactions to utilize the tax benefits, it is possible that further negotiations could possibly have produced better results for FSLIC. It appears, however, that the transactions were appropriate under the circumstances and, as is discussed later, the FSLIC does have some options to terminate certain benefits at less cost.

A key goal of the Southwest Plan is to reduce the overall cost of funds to all institutions. We understand this is happening although higher general market interest rates may interfere for a time as the Federal Reserve now seems intent on pushing for higher rates.

At the same time, a most important thing to remember about past transactions is that the FSLIC notes [redacted]. Thus, as monies are available, FSLIC can typically reduce its cost of funds by paying off some or all of the notes. In addition, to eliminate the yield maintenance commitment in Southwest Plan transactions the FSLIC has the ability to buy back covered assets thus eliminating the yield maintenance and reducing the ongoing cost to FSLIC. Assets can then be placed in the hands of others, probably at lower cost or even handled directly by FDIC or FSLIC. In two of the Southwest deals we understand that FSLIC has some limitations as to pay-offs but these can be minimized. The [redacted]

The FSLIC staff was fully cooperative in our discussions. They are dedicated and working very hard on problems which are very difficult to solve.

This report can be considered to be only a first report. The writer will be pleased to participate further to provide input on the monitoring and approval of asset sales procedures which FDIC/FSLIC will be continually addressing or any other area of the Southwest Plan. This report will concentrate on two major subjects, namely managing and monitoring of the Plan and tax recommendations.

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MANAGING AND MONITORING OF THE SOUTHWEST PLAN

It is very clear that the Southwest Plan will not work well if there are too many barriers in the approval process on proposed asset sales. Initially it looks like too many levels of approval are required which cause delays in approvals and delays are not conducive to making real estate deals. Administrative and unnecessary paper work must be minimized and potential turf issues avoided.

The real key to success for the Southwest Plan is the managing and monitoring of the Plan. It is crucial to utilize [redacted] The individuals in charge of the Plan should all be on-site, and charged with the responsibility to complete the task. The staff must consist of achievement oriented individuals who appreciate the urgency of the situation. They must be people who create results and they must provide top service to the institutions who are handling the assets and to the FSLIC consultants who are assisting FSLIC in evaluating sales of assets. The monitoring process needs to be a real "hands on" approach to make certain that each particular insitution is making a maximum effort to dispose of the assets for the benefit of the FDIC/FSLIC.

In numerous discussions it has surfaced that a good yield maintenance contract can create an apparent incentive to not dispose of covered assets - actually a disincentive. As a covered asset is sold and the gain or loss allocated, the yield maintenance return on that asset is eliminated. If it is found that an institution is not doing the job properly, then with an infusion of cash the FDIC/FSLIC has the ability to buy back covered assets and shift management of them to others, thus also shifting the yield maintenance and hopefully at lower levels of return.

An important point, in the opinion of this writer, is that the monitoring, management and oversight of the Southwest Plan should not be done under the existing organizational approach of FSLIC. This continues to be an extraordinary situation which requires extraordinary management attention. [redacted] Quick decisions create much more enthusiasm for those people handling the disposition of assets. In the MCP Program, the FHLB of San Francisco as the FSLIC representatives, gave excellent service to Great American's MCP managers in approving deals that had been approved by our MCP Board of Directors. This created real enthusiasm and made us work even harder. It can be done.

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TAX RECOMMENDATIONS

After discussions with real estate tax experts, consultants, S&L managers, attorneys, developers and others, it is very clear that certain 1986 tax act changes affecting real estate income properties have been a major factor in causing decreases in real estate values in many markets of the country. Just as favorable zoning can increase the value of real estate and unfavorable zoning can reduce values, likewise for the tax treatment of real estate. [redacted]

As real estate values have diminished the adverse impacts upon institutions and/or FSLIC have been dramatic, especially in the Southwest region of the country. The adverse impacts have been absorbed to a large extent by Texas institutions and other lenders with loans on Texas real estate.

A brief review of the highlights of the 1981 and 1986 tax acts provides significant information. [redacted] institution losses on real estate assets, including existing loans on income properties.

During the 1970s many tax shelters were stripped away. With a 70% tax rate for non-earned income, until dropped to 50% in 1981, real estate became the "shelter of last resort." Even before 1981 therefore investments in income property were favored investments during an era of "shelter mentality."

I. ECONOMIC RECOVERY TAX ACT OF 1981

On August 4, 1981 the Congress enacted and the President on August 13, signed into law a major tax bill called the "Economic Recovery Tax Act of 1981" which among other things, further stimulated investments in real estate income properties, both apartments and all types of commercial real estate. The depreciation period allowed for income properties, which previously was in the 40 year range, was dropped to only 15 years. Accelerated depreciation, to increase annual early year tax writeoffs, was permitted to stimulate capital formation, among other things.

There was no change in the law to limit passive real estate losses from being deducted from ordinary income. For example, a person earning $200,000 per year from his profession or job could invest in real estate

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limited partnerships and any tax losses could be fully deducted from his ordinary income. Some people were able to totally shelter from any income tax their high incomes through such investments.

In addition, the existing law was already structured at that time to provide pass through benefits to limited partners if the general partner obtained a non-recourse loan which provided that foreclosure against the property was the lender's only resort for collection in the event of nonpayment. With a non-recourse loan the limited partners investing in such a project were then permitted to fully deduct the passive losses which were passed through by the general partner. These losses could be well in excess of the actual investment by limited partners.

The use of accelerated depreciation coupled with 15 year amortization of depreciation on income properties, plus the passive loss rules dramatically increased the benefits for real estate investments in 1982 and thereafter. It is reported that as much as $40 billion in equity investments were put into real estate projects (income properties) in 1982 alone. The pass throughs of losses in some instances were as much as $2 or $3 for every $1 in cash invested. The result was that real estate, as the already favored tax shelter, became even more favored due to 1981 tax changes.

~~The additional tax advantages provided to apartments and commercial real estate in the 1981 had two impacts. First, many real estate projects that were not economically sound were commenced.~~ A developer or syndicator with a non-recourse loan (no personal or corporate liability) for the real estate debt was not "at risk" to the lender even if his real estate project was not viable. Many projects were "overly tax structured" and not "need driven". This unintended result triggered overbuilding in certain areas of the country, with emphasis on the Sunbelt and particularly in the state of Texas where problems began to surface in 1984 as the general economy of Texas began to deteriorate.

~~Second, the [illegible] use of these authorized limited partnerships were later viewed as tax abuses.~~ The later abuse of the authority created an incentive and a need for the Congress to act to correct the problems created in the 1981 tax bill. In The five year period between the 1981 and the 1986 tax bills the "tax driven" mentality however created many unneeded commercial and apartment projects, thus contributing significantly to an overbuilt situation in a number of areas of the country. Even many "feasible" projects, financed by good lenders, were made "unfeasible" by later resales at inflated prices to capture even more tax benefits. Rental income on properties dropped thus reducing values.

Conscious of growing abuses, Congress acted in 1984 and 1985 tax legislation to increase depreciation periods to 18 and 19 years but continued 15 years for low income housing. These modifications were minimal and not any kind of "warning" for what was to come in 1986.

II TAX REFORM ACT OF 1986

In 1986 the Congress passed (September 25 in the House and September 27 in the Senate) and the President signed (October 22) the "Tax Reform Act of

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1986". This was the most extensive overhaul ever of the 1954 U.S. Tax Code. The 1986 act corrected the so-called real estate tax abuses on the use of passive losses on a retroactive phase-in basis rather than on a prospective basis. ~~The changes meant that many previous real estate investments were put in jeopardy, however, in many cases it was the lender and not the developer who bore the ultimate risk.~~

The deductions of passive losses from real estate activity against ordinary income, which is what limited partners in income property projects received, were phased out on a retroactive basis, dropping to 65% in 1987, 40% in 1988, 20% in 1989, 10% in 1990 and none thereafter. In situations where passive losses exceeded passive income, the 1986 act permitted excess passive losses to be "put on the shelf" and allows them in the future to deduct against future passive income. The IRS however, has been very "tight" and also "slow" in developing its regulations so that it is not easy to generate passive income to pick up the excess passive losses.

We are unaware of any rationale for changing the passive loss rules on a retroactive basis other than for federal revenue purposes. The result of not making the changes prospective, though certainly not intended and not contemplated, has resulted however in many losses to the FSLIC which has been forced to pick up the asset and loan losses of failed institutions. The states of Arizona, Colorado, Louisiana, Oklahoma and Texas have particularly been hard hit by "tax driven" overbuilding and has exacerbated the problems in states with poor overall economies.

As loans on projects became delinquent many borrowers, who otherwise could or would have put more money into a project to keep loans current, decided that with the reduction of tax benefits and declines in property values, no incentive was there to continue so lenders wound up taking back many properties. Even with drops in property values due to poor economies and overbuilding, many borrowers would have continued to keep their loans current if negative cash flows could be offset by the tax benefits.

As a result, not only has the FSLIC experienced losses, but lending institutions all around the country that have made income property loans have seen their existing loans made on otherwise sound and feasible projects put in jeopardy through ruinous competition with "tax driven" projects. One interview with a major institution in the Southwest Plan indicated that the Texas institutions combined together in the resulting institution had previously sold 644 separate loan participations to other savings institutions in 26 different states. Institutions in many states had shifted to buy participations in income properties after sales of good single family packages became difficult to obtain. The addition of non-feasible and unneeded projects to certain real estate markets has had an adverse effect upon all existing income properties in the particular areas of overbuilding.

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Existing viable institutions are finding, as is the FSLIC, that it is much more difficult to sell foreclosed real estate than it was in the past. One of the reasons for this is the fact that the 1986 tax act not only changed the passive loss rules to create somewhat of a disincentive for that type of investment, but also extended the depreciation period allowed from 15-19 years for income properties as permitted in previous legislation, to 27 1/2 years for apartments and 31 1/2 years for commercial projects. Also accelerated depreciation on real estate was banned in 1986 which further reduced tax benefits. Thus, new real estate investors now face a much longer period of time to recapture their investments and as a result there are fewer buyers.

In addition the 1986 tax act changed certain of the "at risk" rules for the first time to include real estate investments which for some created a new disincentive to investments in real estate. The application of the "at risk" rule to real estate means that in certain cases investors can no longer take deductions or losses beyond the monies they have invested in the project. Generally recourse debt can be added to the investment amounts for purposes of taking deductions while seller taken back non-recourse debt cannot be included, which means fewer deductions for tax purposes.

Another twist to the "at risk" law involves the sale of foreclosed real estate by a lender. If a lender forecloses and takes title to the real estate, the loan to a subsequent purchaser made by the lender is considered "seller financing" and the loan cannot be treated as "qualified non-recourse financing" for the borrower's amount of investment "at risk".

The basic approach in selling foreclosed income properties by lenders has therefore been changed somewhat as a result of the new application "at risk" rule to real estate. Now, for many lenders, the approach is typically to sell foreclosed real estate for cash rather than sell and take back a loan even though it would be cheaper and easier to finance the sale. An outside lender can provide "qualified non-recourse debt" and thus the buyer gets more tax deductions than if the seller/lender made the loan.

In addition, since typically lenders do not charge fees to buyers of their foreclosed property, it means that the buyers, in borrowing elsewhere, must pay loan fees and other expenses to other lenders in order to buy foreclosed real estate from the seller/lender. Values are also sometimes lower without seller financing. Also some lenders are reluctant to finance the "troubled" real estate of other lenders. In addition, the fact that a seller/lender can typically close a real estate deal faster than another lender means that a further sales impediment is added. The overall result is fewer buyers because of the disincentives to invest in foreclosed real estate with the clear result of adverse effects upon the real estate values and the prices the fewer buyers will pay.

III SOLUTIONS TO CONSIDER

It is suggested that use of the tax code to help facilitate the sales of foreclosed real estate be quickly reviewed to see in what ways possible

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changes in the tax code can be used to help the FSLIC, FDIC and insured financial institutions stimulate the sale of foreclosed real estate for a period of time. Some suggestions to consider are as follows:

1. Restore full passive loss deductions against all income for purchasers, including limited partners, of foreclosed real estate (apartments and commercial) purchased from FSLIC, FDIC, banks, savings banks and S & Ls during the three-year period from 3/31/89 through 3/31/92.

2. Make these benefits available for any real estate subject to existing loans now held by banks, savings banks and S & Ls on commercial real estate and apartments that are foreclosed and resold during the three-year window period, provided the loan was made after August 13, 1981 (date of 1981 tax enactment) and before September 27, 1986 (date Senate passed the 1986 tax bill after House acted on September 25). The dates suggested tie into the time period during which loans were made on properties with the beneficial 1981 changes available to investors.

3. The deductions of full passive losses should continue against any other income of investors, including limited partners, for so long as they own the income property provided the property was purchased during the three year window period.

4. Return depreciation to 15 years for sales of foreclosed apartments and commercial real estate for the three year window period.

5. Permanently exempt the sales of foreclosed real estate by FDIC, FSLIC and insured institutions from the "at risk" rules so as to make it clearly feasible and beneficial to buyers for the seller/lender to provide financing to facilitate sales.

The goal of a partial short term restoration of the full 1981 and prior tax benefits would be to [redacted]

We recognize that the reopening tax benefits for certain real estate will create some inequities in the real estate finance system. It would be very important for real estate experts along with representatives of the key congressional committees (House Ways and Means and Senate Finance Committee) the Administration, FDIC, FSLIC, FHLBB, and Treasury to consider all of the facts before acting. For example, it would appear that to permit the deductions for purchasers of foreclosed real estate from only the FDIC or FSLIC [redacted] This is a delicate issue.

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It would seem that tax code changes to permit 15-year depreciation and the exemption of FDIC/FSLIC and insured institutions owned foreclosed real estate from the "at risk" rules could be done immediately for the sales of foreclosed income properties by FDIC, FSLIC and all insured institutions. Such action would be very simple and be of immediate help while the other tax issues are subjected to more careful scrutiny. The key however to big help for FSLIC/FDIC/insured institutions clearly appears to be the restoration of the full passive loss deductions for foreclosed real estate along with the 15 year depreciation and exemption of the "at risk" rule.

A quick review and study could also determine if the creation of some of the proposed incentives to purchase foreclosed real estate would cause less revenue loss for federal government than would be the case if increasing FSLIC losses are not reduced by the use of more tax incentives in sales of foreclosed income properties. If FSLIC institution losses continue to escalate because real estate cannot be sold sooner and at better prices, it will probably mean an increasing need to tap additional funds for FSLIC from the Treasury. In addition, there will be situations where low net worth institutions will be benefited by being able to convert problem assets to earning assets or cash thus assisting in their continued viability, further lessening future problems for FSLIC/Treasury.

Although this writer does not consider himself to be a tax expert, it is his opinion, based upon many discussions, that the tax proposal has great merit and needs quick review and consideration. The 1986 tax changes for real estate investments need to be revisited.

CONCLUSION

The fact that the FDIC has now been assigned the task of supervising the FSLIC does not alter the need to have top people monitoring and providing oversight on the ongoing operations of institutions already involved in the Southwest Plan. There is a particular need to have many experienced real estate oriented personnel representing FDIC/FSLIC. This is important because the institutions in the Plan are primarily real estate lenders and investors. Permitting decisions to be made in Texas rather than in Washington is a key to making the Southwest Plan work.

Tax recommendations in this report are of particular importance. The tax law changes in 1986 did, in fact, hurt real estate values and the portfolios of real estate lenders much more than anyone could have possibly anticipated. The magnitude of the real estate losses was hard to recognize until very recently. The difficulty in estimating the real estate losses and in recognizing just how severe the tax impact has become, appears to be a major factor in the increasing forecasts of FSLIC losses.

Overbuilding in many areas, including the development of many "tax-driven" income property developments, has had a very adverse impact upon insured financial institutions around the country, as well as the FSLIC and FDIC. A plan to restore some of those tax benefits for a period of time will help alleviate the situation and necessitates a strong recommendation to go forward.

Great care, however, must be taken to consider the whole market place and also include existing banks, savings banks and S & Ls, who are not FSLIC or FDIC cases, in any tax benefit changes to help dispose of foreclosed real estate so that the overhang of non-earning assets in the form of income property is reduced industry-wide. Any tax benefits for the purchase of foreclosed real estate should therefore be extended to purchasers from insured financial institutions as well as the FSLIC and FDIC.

It also must be remembered that the Southwest real estate problems are not just the problems of Texas financial institutions, as institutions from almost every state in the country have made loans or purchased participations in loans in the Southwest, especially in Texas. Overbuilding is not, therefore, just a Southwest problem, but a national problem.

On a follow up of a recommendation made in the 1987 MCP report for the FHLBB it is pleasing to see that the Office of General Counsel is setting up field offices in Texas and California. From our experience, there must be more field involvement and control over the many legal matters involved in the various FSLIC cases and liquidations. This should include the use of more house counsel working for institutions to assist FSLIC in monitoring its vast legal caseload and helping to settle legal problems and reducing legal expenses. "Hands on" monitoring and review of legal activities in the field are crucial.

In summary, while fraud and self-dealing in certain financial institutions have been widely discussed, the tax changes in 1986 did contribute significantly to the loss scenario. The highlighting of the impacts of the tax changes in this paper is not done to suggest that the changes are the major cause of the FSLIC problems; however, it is clear the changes are one of a number of major causes and further are an impediment to the disposition of foreclosed real estate.

When the use of the excessive direct real estate investment powers, particularly in California and Texas, and along with the ability since 1982 (under deregulation) to make 100% loans on real estate projects is added to the "tax driven" mentality, the total impact is more severe. Proposals to make the sale of foreclosed property more attractive will reduce FSLIC losses and help improve the viability of the overall thrift industry.

It has been a pleasure to again assist the FHLBB in its need to address the increasing problems it must deal with.

First Federal
Savings and Loan Association of Rochester

Thomas N. Borshoff
President and
Chief Executive Officer

FEB 31 2 05 AM '89

March 2, 1989

Mary A. Creedon
Acting Director, FSLIC
1700 G Street, N.W.
Washington, D.C. 20552

Dear Mary:

Enclosed is the report on the Southwest Plan requested by Chairman Wall.

We would be happy to discuss the report with you and your staff; and to provide follow up reports if requested to do so.

We appreciate the opportunity to have been included in this project, and hope that our recommendations will prove to be beneficial to the FSLIC and to its implementation and monitoring of the Southwest Plan.

Very truly yours,

Thomas N. Borshoff

Thomas N. Borshoff
President and
Chief Executive Officer

TNB/mg
Enclosure

One First Federal Plaza, Rochester, N. Y. 14614, (716)454-4010
Member FSLIC

REPORT ON
THE SOUTHWEST PLAN

March 2, 1989

Thomas N. Borshoff
President and
Chief Executive Officer

First Federal Savings and
Loan Association of Rochester
Rochester, New York

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REPORT ON
THE SOUTHWEST PLAN

OBSERVATIONS

We have been asked to review the Southwest Plan ("Plan" or "SWP") as adopted by the Federal Home Loan Bank Board ("FHLBB") and to offer recommendations for the administration of the Plan over its expected life. We have reviewed the materials provided to us by the FHLBB which covered transactions closed through November 18, 1988, have met with representatives of the FHLBB and the Federal Savings and Loan Insurance Corporation ("FSLIC"), and discussed this matter with various other members of the thrift industry.

The large number of transactions and the tremendous volume of materials relating to the Plan generally, and to individual transactions specifically, made it impossible to conduct an exhaustive review given the short time frame of this assignment. It should be noted that we did not review the details of any of the transactions under the Plan, and specifically did not review or analyze the bid packages and the financial aspects thereof. Nor did we review the lists of interested bidders on each transaction and their financial resources and resumes, or have an opportunity to reach any conclusions as to their motivations in wanting to own and operate a thrift institution under the Southwest Plan. These limitations made it impossible for us to make any comments or reach any conclusions about the reasonableness or wisdom of any particular transaction. We would welcome the opportunity to conduct a more thorough analysis and generate a supplemental report that addresses these issues if requested to do so.

Our review, however, does allow us to make some general observations about the Southwest Plan. It is important to recognize that the Plan is an attempt to resolve a problem that has been years in the making. It is arguable that today's problem is the culmination of a series of events tracing back over 20 years to Regulation Q and its impact on the profitability of the thrift industry. Deregulation of liabilities in an industry with long-term, fixed-rate assets,[1] followed by escalating interest rates led to balance sheet mismatch, operating losses and net worth depletion.[2] (See presentation of Andrew S.

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[1] It should be noted that the FHLBB first asked Congress in the mid-1970s to grant thrift institutions the authority to make adjustable rate loans.

[2] Some industry observers have suggested that those institutions that experienced spread problems in the early 1980s are the same institutions that are now the source of the problem, and that FSLIC should have liquidated or merged "them" a long time ago. We believe that is an inaccurate observation. For the most part, the institutions that experienced spread problems in the early 80's are not the same institutions that are experiencing problems today. Today's problems flow primarily from poor asset quality which is the result of a number of factors, not the least of which are growth binges by state chartered thrifts managed by new owners with, in many cases, questionable motives.

Carron, Vice President, First Boston Corp., to the Federal Home Loan Bank of San Francisco, December, 1988.) One can debate the relative contributions made by regulators, legislators and thrift management to the problem. One also can not ignore the impact that granting expanded investment authority, particularly to state chartered institutions, and the dislocation in the world economy and money markets, particularly the sustained collapse of the price of oil, have had on leading many of the thrifts in the Southwest to the point where they are today. Suffice it to say that all share some responsibility for that small percentage of the industry and the problems it has caused for the FSLIC.[3]

A historical analysis is interesting and educational, and may prevent similar mistakes from being made in the future. It does not, however, solve the problem. The losses are substantial, and for the most part are fixed. The efforts of Congress, the regulators, the Administration, and the industry should now properly focus on solving the problem and allowing the solvent majority of the industry to focus on its primary mission -- encouraging thrift and promoting homeownership.

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[3] Many people we interviewed in Texas felt that the retroactive change in the tax laws as respects passive real estate investments had a very negative impact on Texas real estate values.

The central feature of the SWP is a focus on the consolidation of insolvent thrifts with some combination of healthy institutions, together with capital infusions. The benefits to be gained from consolidation as stated in FHLBB Resolution No. 88-68 are: significant savings in operating expenses; management teams capable of providing the leadership and controls necessary to achieve viability; the ability to permit higher cost deposits to be reduced by cash flow from investments supported by lower cost deposits; merging within one institution complex financial investments that currently are located in several institutions, with attendant unnecessary costs; and attracting capital to a market that currently has too many inefficiencies to produce a reasonable return on new capital.

Prior to adoption of the Plan, the FHLBB initiated an analysis of possible means to reduce operating and deposit costs in the Ninth District. That analysis revealed the following points, which were adopted as premises to the aforementioned resolution:

- Consolidation would provide for an integrated approach to the existing insolvencies rather than resolving cases less effectively on a case-by-case basis;

- Fourteen geographical regions can be identified in Texas; consolidation should occur within the framework of those geographical market areas, some of which are local, some regional, and some multiregional (but not statewide);

- Consolidation could significantly reduce the number of savings and loans and deposit-gathering offices within those markets;
- Consolidation should provide immediate operational savings, exclusive of conversion costs, of several hundred million dollars per year;
- Additional, even greater, savings may be achieved through resulting reductions in the cost of funds to insured institutions throughout the Ninth District;
- Further savings are possible through the consolidation of shared complex financial assets in a single institution, eliminating or simplifying management costs and litigation;
- The key to these savings, as well as to reducing the long-run cost to the FSLIC, is the identification and selection of strong management;
- By retaining an interest in the future profits of assisted institutions and their assets, the FSLIC

stands to share in the savings that result from the plan.

Recognizing these factors, the FHLBB, on February 3, 1988, approved a strategy of consolidation and directed the FSLIC, in consultation with the appropriate state and federal regulatory agencies, to do the following:

- Within the limits of the Board's authority, identify and foster the retention of the most capable management in the consolidated institutions, with a view toward both satisfying the institutions' immediate needs for capable management and minimizing the long-term costs of the FSLIC;

- Develop such a strategy that will consider the multiregional nature of the Ninth District in general and the State of Texas more specifically;

- Provide a procedure that will permit new capital to be introduced into consolidated local, regional, and multiregional institutions within Texas on a cost-effective basis;

- Promote fairness by providing potential investors and managers the opportunity to compete for the right to participate in the plan on an equitable basis, to the ultimate benefit of the FSLIC fund;

- Foster the consolidation of complex financial assets in which conflicts among participants are raising costs;
- Provide necessary procedures and staffing for continuing a strategy of consolidation; and
- Proceed with implementation in as expeditious a manner as possible.

For purposes of this report, we have accepted, without review, the premises and objectives of the Plan. We have also accepted, without review, the adequacy of the selection procedures for acquirers; and are proceeding on the assumption that the procedures adopted have resulted in the selection of those acquirers who have the capabilities to fulfill their responsibilities at the least cost to the FSLIC.[4] The focus of this report will be on some of the more macro elements of the Plan, and on those factors that will impact the ultimate success thereof.

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[4] We do note that the lack of a clear statement that the full faith and credit of the United States supports FSLIC notes has led a number of potential acquirers not to pursue participation in the Southwest Plan. The impact of this and the cost to the FSLIC are discussed in Recommendation I.

Our observations are as follows:

(1) It is critical to acknowledge that the majority of the real estate losses that will be incurred during the life of the SWP have probably already been realized. It is obvious that the true value of these thrifts is substantially less than might be indicated by their stated asset size. The Plan recognizes that the losses relating to covered real estate assets have already been incurred. The Plan is based on the premise that there is insufficient cash to pay for these losses today and is, therefore, a financing vehicle designed to pay for those real estate losses over a period of years.

(2) For purposes of discussion and analysis, it is important to view each case resolution in the Plan as two distinct transactions: a) the sale of the core thrift franchise to the acquirers; and b) retaining real estate expertise to oversee and manage the disposition of troubled assets. It is important to recognize that running the core business of a thrift and managing distressed real estate assets requires two distinct skill sets. Given the magnitude and complexity of the real estate-related problems in these institutions, we believe that highlighting this distinction will focus attention on ensuring that the necessary resources and expertise are directed to the management of the troubled assets. This issue is discussed at more length in Recommendation I.

(3) Once it has been acknowledge that the FSLIC is really selling the acquirers a core franchise and the right to operate that franchise pursuant to the terms of the Assistance Agreements, it should be recognized that the capital contribution brought to the transaction by the acquirers should be viewed, not in relation to total assets acquired, but to the true value of the franchise, that is, total assets less covered assets. (See Second Annual Report of the Federal Savings and Loan Insurance Corporation Industry Advisory Committee to Congress; Pages 44-45.)

(4) In most cases, the FSLIC specifically has preserved for itself a share of future tax benefits and operating profits that may flow to the acquirers, and the upside potential from the disposition of currently depressed Texas assets. It has done this by drawing on the expertise and entrepreneurial abilities of the private sector, and by placing new management in these institutions.

This latter factor recognizes that a government agency will never be as effective as the private sector in dealing with what would otherwise be the FSLIC receivership assets. Furthermore, because FSLIC has retained the right to repurchase covered assets and to approve all transactions relating to the disposition of covered assets, it can exercise considerable control over individual institutions and over the flow of these assets into the market.

We believe that this partnership with new management, coupled with close monitoring and oversight by the FSLIC, is the key to the ultimate success of the Plan. It establishes the motivations in both partners to ensure that efforts are focused and, when necessary, refocused on achieving the stated objectives of the Plan. The structure of the Plan also gives both the FSLIC and the acquirers the incentive and the time to maximize the return to the FSLIC by proceeding in an orderly manner to understand the value of each of the troubled assets and to dispose of them in a controlled rather than a fire sale environment.

(5) It appears that losses incurred by insolvent institutions in the southwest generally flow from three areas: (a) non-performing real estate loans and real estate owned; (b) the cost of financing the negative net worth; and (c) continuing general and administrative operating expenses.

Absent a further serious dislocation in the Texas economy, we believe that the large majority of the losses that will be incurred are already fixed and predetermined. Furthermore, the cost of "a" and "b" above, and, likewise, the potential upside is far greater than the cost or upside of "c". Given the above, the resources of the FSLIC should be allocated accordingly.

(6) The SWP, in so far as it is predicated on effecting consolidations with resulting economies of scale, is working. As of December 31, 1988, of the 836 branches of institutions in the

Plan, 180 have been closed or consolidated. These consolidations are the first necessary steps to effecting further saves in all expense lines.

(7) The high level of the Texas cost of funds has had a negative impact on institutions in that state and across the country. The implementation of the Plan is eliminating from the marketplace those insolvent thrifts that found it necessary to pay up for liabilities to support their balance sheets. On January 1, 1988, the Texas cost of funds on short-term, non-jumbo Certificates of Deposit was 1.34% over U.S. Treasury Rates. On June 30, the spread over Treasury Rates was .58%, a decline of 76 basis points or 57%. (See Second Annual Report of the Federal Savings and Loan Insurance Corporation Industry Advisory Committee to Congress; Page 29).

(8) The SWP has stabilized the situation. Prior, often incompetent management has been replaced by management with the expertise to curtail mounting losses. IT SHOULD BE RECOGNIZED, HOWEVER, THAT THE PLAN IS NOT OVER, OR EVEN NEARLY OVER. RATHER, IT HAS JUST BEGUN. ITS ULTIMATE SUCCESS DEPENDS ON HOW THE PLAN IS MONITORED AND ADMINISTERED, AND, IN PARTICULAR, HOW COVERED ASSETS ARE MANAGED. THE FINAL SCORECARD ON THE SUCCESS OF THE SWP WILL NOT BE MEASURABLE FOR SEVERAL YEARS. If one accepts that the losses on covered assets have already been incurred, it is logical to focus resources in the future to ensure that additional losses are minimized, and that the substantial upside

potential that exists is realized. The future benefits to be realized from the proper management and disposition of covered assets relate to increased property values, improved cash flow and greater recoveries from the sale of REO. These benefits will ultimately be shared between the acquirers and the FSLIC in the form of tax benefits, and in the final analysis, increased value to the warrants held by the FSLIC.

(9) The job facing the FSLIC and the acquirers is massive, and requires the largest commitment of resources in recent history to the management of real estate assets which directly affect the economy of a major geographic area of the country, and, indirectly, the economy of the entire nation. It is difficult to exaggerate its size, scope and complexity. The following information, however, is instructive on this point: a) as of September 30, 1988, there were $13.278 billion in assets held by 35 institutions in the Plan, with a collective tangible net worth of <$5.384 billion>; and b) as of December 31, 1988, the 23 Southwest Plan Assistance Agreements dealt with almost $34 billion in covered assets.

These statistics begin to demonstrate the problem; but they also demonstrate that there is a substantial upside potential for the FSLIC. If properly managed, the return on real property assets can be maximized; and the cost of defending lawsuits and any liability thereunder can be minimized.

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(10) Our review of several assistance agreements suggests that the generic agreement contains provisions that allow the FSLIC to control the acquirers' conduct, and when necessary (if cash is available), repurchase covered assets and take other appropriate enforcement actions. We have also interviewed representatives of the FSLIC and FAD, the SWP Regional Coordinator and on-site contractors. These interviews lead us to conclude that the follow-up structure is in place to carry out these transactions over the next several years in as successful a manner as any other alternative could have allowed.

These factors lead to our primary recommendation. It is imperative that adequate resources be made available to the FSLIC to enable it to further develop appropriate policies and procedures to monitor the activities of the acquirers and to ensure that its "joint venture partners" are performing as expected and pursuant to the requirements of the Assistance Agreements. It is our observation that the process of putting these resources in place is well underway. We mention this factor only to note its importance and to emphasize how critical it is that this process continue, and that all needed support be provided. This will not only optimize the success of the Plan, but also enable the FSLIC to remain attentive to its ongoing regulatory responsibilities with respect to these and other institutions.

What follows are a number of specific recommendations that, if implemented, will give the FSLIC the resources it needs, and put in place those elements required for the successful conclusion of the SWP.

RECOMMENDATIONS

I. THE FULL FAITH AND CREDIT OF THE FEDERAL GOVERNMENT MUST STAND BEHIND THE FHLBB, FSLIC AND THE BANK SYSTEM

The cloud which hangs over the FSLIC and Bank System credit status clearly drove up the cost to the government of the SWP assistance agreements, reduced the number of interested acquirers and made negotiations more difficult. The FSLIC and FHLBB should aggressively pursue efforts to raise the credit standing of the System and obtain full faith and credit for all of its obligations including FSLIC's notes and its contractual obligations to provide yield maintenance on covered assets. Success in this effort will lower the ongoing cost of previous transactions, raise the profitability of SWP acquirers (through improved credit ratings), lower the cost and increase negotiating power on future case resolutions, and increase the profitability of the entire industry when such profits are badly needed. An alternative which would provide ongoing cash flow to the FSLIC would take the amount of the spread improvement in Consolidated Debit Obligations and FICO Bonds generated through full faith and credit, and divert this spread to the FSLIC. If, in fact, the government stands fully behind these obligations, this spread is needlessly being passed onto investors.

II. THE FSLIC MUST MARSHAL AND DEPLOY SUFFICIENT RESOURCES TO MANAGE THE PROCESS

A key element in the SWP is to involve the private sector as joint venture partners in working out and disposing of covered assets. The core institutions are effectively sold to the acquirers along with the risks inherent within them. The cost of carry and risk of loss associated with the covered assets essentially remains with the FSLIC. The private sector, in the form of the acquiring institutions, has been attracted to manage and dispose of these assets through the use of yield coverage and certain gain sharing arrangements. There is no doubt that these private sector partners will seek to maximize their benefit within the relationship, and the FSLIC must have the oversight and decision-making capacity to channel the motivations and actions of its partners to the FSLIC's benefit. Several specific recommendations follow which we believe will aid in optimizing ongoing relationships with private sector acquirers:

(1) The FSLIC has established a network of approved contractors to act as front line, on-site managers of the partner relationship and evaluators of the process of disposition of covered assets. We strongly support this approach and recommend that each assistance agreement continue to be assigned to an independent contractor. We believe each contractor should operate on an arms-length basis, as agent for FSLIC, in maximizing the financial benefit to the FSLIC within the assistance

agreement. Their primary area of expertise should be in the management, evaluation and disposition of real estate, since the FSLIC's financial risk is concentrated in this function. While consolidation and operational progress should be monitored, this should not be the focus of review or a basis for contractor selection since the financial risks and benefits of this process flow directly to the acquiring institution and are not shared with the FSLIC directly. The FSLIC does share in equity positions, but on a minority basis. With over $40 billion in covered assets, clearly real estate expertise must be paramount in the contractor function.

We would additionally encourage the periodic rotation of contractor firms among assignments. Given the close working relationships which will develop over time, there exists the potential for independence to be impaired and for pressure on acquirer's performance to be relaxed. Additionally, rotation will minimize the negative effects of these tedious assignments and bring fresh, new approaches to bear on covered asset issues. Obviously, these benefits must be weighed against the learning curve each new contractor must overcome in order to be effective.

(2) As perhaps the largest stakeholder in the future of Southwest property values, the FSLIC must develop or access a continuing knowledge base second to none concerning the discrete, segmented real estate markets. While the contractor network and the FSLIC approval process will be dealing with individual asset

management or disposition plans, a thorough understanding of the condition of each geographic and property type real estate market must be maintained in order to provide a context within which to make optimum decisions. A FSLIC Management Information System ("MIS") is being developed to meet this objective. Pending completion thereof, an interim system using contractor support is being implemented. This interim system is designed for efficient integration into the FSLIC MIS.

It has been said that the worst action would be to put all covered assets on the market and the second worst action would be to hold them all off the market. In each geographic area, by property type, an overall plan should be developed and maintained to allow for covered assets to be exposed to and absorbed into the market in a manner which will assist in the orderly return to a proper balance of supply and demand. This understanding of the real estate markets and macro-level planning will not only assist the FSLIC and its contractors in making coordinated and positive decisions, but will protect the real estate industry and markets throughout the southwest from the dislocation possible in mismanagement of what is soon to be a $40 billion portfolio.

This expertise could be developed internal to the FSLIC, in conjunction with the Dallas Bank, or through utilization of outside sources. It will represent a major determinant of the success of the SWP through the 1990's, and will assist in dealing with the FSLIC's partners on an equal basis.

(3) Within the FSLIC, a centralized data collection and policy-making function should be developed to provide structural guidance to field staff and contractors in dealing with the myriad of issues related to asset management and disposition. Policies should be developed and communicated including, for example:

a) approval levels;
b) format of disposition plans;
c) output from the market knowledge gained in "2";
d) available financing for different asset types;
e) use of brokers;
f) contractor reporting requirements; and
g) enforcement actions regarding non-compliance.

Additionally, this group should act as a data collection and analysis function in summarizing all activity within SWP agreements for the purpose of reporting results, comparing performance between acquirers and updating proforma cost estimates.

After all SWP covered assets are identified and summarized, and the FSLIC's access to cash is quantified, this function can focus in on the asset types with the least chance of appreciation and the highest cost of carry and provide guidance to field staff as to priorities to be used in reviewing disposition plans. We are advised that a standardized hold/sell model is being developed which will allow this function to provide uniform guidelines to all field staff in reacting to acquirer proposals.

We understand that this process is well underway, and strongly support its timely completion and maintenance as another crucial factor in simplifying an enormous administrative challenge and optimizing FSLIC's financial involvement in the SWP.

(4) Just as the 1988 FSLICIAC report to Congress recommended that "the expedited case processing program should be expanded and become the preferred method of disposing of failed institutions," an expedited decision-making process must be developed and implemented as the standard method in fulfilling the FSLIC's role as the owner of covered assets. A bureaucratic or regulatory approach must not be allowed to develop. Rather, a business approach similar to that in a corporate process, must be established and fostered. To the greatest extent possible, FSLIC decision makers should be placed in the field to facilitate close contact with partners and contractors, supported by the centralized real estate and policy functions previously recommended, and encouraged to make as many decisions as possible without involving other layers of approval.

We are advised that a productive, workable structure is already in place whereby FSLIC field staff are interacting with partners and contractors in a timely and authoritative manner to the satisfaction of all parties involved. However, its capacity is currently constrained by limited staff and administrative resources, as evidenced by the fact that a single case manager is now responsible for over $10 billion in covered assets. This matter is being addressed by the latest staff increase; however, existing requirements together with requirements resulting from expected consolidations are likely to soon overwhelm even that increased staff level.

The FSLIC must proceed in an expeditious manner to draw upon the human resources of the FHLBB and Bank System to expand this staff of front line decision makers and vest in them the maximum level of authority prudently grantable. As contractors are assigned to the transactions done in December, 1988, and these acquirers proceed with operational and covered asset plans, they must be able to deal with FSLIC field staff who are knowledgeable, confident and not overburdened. This FSLIC staff should include an appropriate number of senior-level executive positions. It is not unreasonable to allocate, on an annual basis, an amount equal to 10 basis points of the covered asset portfolio for the FSLIC to retain the number and level of resources necessary to properly manage and monitor that portfolio and protect its interests therein.[5]

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[5] It should be noted that the FSLIC is "on budget", whereas the FDIC is "off budget". We have not analyzed the ramifications of this distinction; but suggest that this puts the FSLIC at a competitive disadvantage in attracting and retaining the resources it will need to fulfill its responsibilities. This

(Footnote Continued)

We believe that the interaction of the partners during the first six months of each assistance agreement will set the tone for the continuing expectations of the parties. In significantly leveraging its capabilities through the contractor network, the FSLIC must complete the process by providing timely and authoritative decision making in the field for the thousands of requests which must be acted upon. As an example of the importance of this system, the FSLIC must respond to specific requests for approval of covered asset dispositions in as little as 20 days in some instances, or waive its right to such review and approval. If the field staff structure and personnel are not significantly expanded, the FSLIC will risk the loss of its rights with respect to covered asset dispositions.

Equally important as the interaction between the acquirer, contractor and the FSLIC is the relationship between the acquirer and a proposed purchaser of a covered asset. Through its review and approval procedures, the FSLIC must send a clear message to the real estate markets that covered assets are being professionally managed and marketed, that the FSLIC is aggressively supporting the disposition of these assets, and that there are real advantages to a buyer in purchasing a covered asset versus a similar asset held in private hands.

(Footnote Continued)
distinction should be examined in detail, and if our assumptions are correct, appropriate action taken to put the FSLIC on par with the FDIC.

Given the crucial nature of the field office structure and personnel established above, we are uncertain if this challenge can be fully met within the civil service structure. The FSLIC should give consideration to alternate means of attracting and retaining the talent required to manage the largest portfolio of troubled real estate assets in the country.

(5) Apart from covering negative net worth and covered assets with notes, the next most significant financial obligation of the FSLIC is to manage and resolve the thousands of current and expected lawsuits filed both against and on behalf of SWP institutions. The standard approach to handling this issue within the assistance agreements has been to indemnify acquirers for the costs of managing and settling these cases on a dollar-for-dollar basis. We assume that acquirers will be motivated to resolve cases in the best interests of the FSLIC, as they are obligated to use their "best efforts" in this regard, and they should be interested in reducing their case load in general; however, there are no compelling financial incentives within the agreements to reward such efforts.

Given the complex and ambiguous nature of the litigation exposure, this structure may be the most workable. However, we believe that a centralized policy and data management function supporting a substantial field force, similar to the recommended approach to covered assets, must be implemented in order to manage perhaps the largest litigation docket ever assembled in the financial services industry. We understand that OGC is in the process of establishing a field office, and we strongly support this move. This office should be well staffed with attorneys and professional support staff. Counsel should be viewed as dedicated resources for the resolution of Southwest Plan cases only, and not be diverted to other legal matters within OGC. Two factors will be primary determinants of the success of the litigation management effort. Acknowledging the "soft" aspect of the acquirers reward structure, the FSLIC must play a forceful, proactive role in case resolutions. Additionally, since a majority of current and expected litigation involves covered assets, a high degree of coordination must be established between litigation and covered asset management functions, both at the central policy making level and in the field offices. As we observed in the covered asset area, the approach and positions established in the near term future will set the tone for how plaintiffs and acquirers perceive the FSLIC's resolve in managing this function.

III. SWP INSTITUTIONS MUST RETURN TO CORE BUSINESSES

Consolidation is a primary foundation of the SWP. This process includes two distinct activities and benefits. Through the combination of several cases into a transaction package, the FSLIC has created the opportunity (and requirement) for acquirers to consolidate not only corporate and support functions, but additionally, to rationalize branch networks. The financial benefits of this process are significant and flow directly to acquirers, and indirectly to the FSLIC, through its equity positions and the recreation of a profitably structured southwest thrift industry. Acquirers are required to prepare consolidation plans and status reports to the FSLIC on their progress. While this process must be encouraged and enforced, we believe the incentive structure will strongly motivate rapid consolidation of overhead and branch networks.

The second consolidation process will be to return the SWP institutions to asset sizes more reflective of their core customer liability bases. The SWP acknowledges the dual makeup of acquired balance sheets by, in essence, selling the core business outright and requiring capital to be infused to support this core, and then retaining the acquirer as management agent to workout and dispose of covered assets. As the process of disposition and amortization/prepayment proceeds, any liquidity generated must be used to reduce the non-core liability base, which will assist in alleviating pressure on both system obligations and nationwide liability rates, reducing both the Texas and FSLIC premiums. The enforcement of this return to more normal liability structures will not only preserve the capital ratios of the SWP institutions, it will have a beneficial impact on the profitability of the industry as a whole. This recommendation is integrally tied to Recommendation VII in that much of the cash to feed this process will flow from the FSLIC.

IV. FSLIC SHOULD INTERNALLY REVIEW ASSISTANCE AGREEMENTS

During the conceptual and design phase of the SWP, it was hoped that assistance agreements would be essentially identical, with only minor differences in terms and conditions. A cursory review of agreements entered into through November indicates that while a basic framework is common, there exists significant and numerous differences unique in many cases to each transaction. These differences necessarily flowed from the changing negotiation environment and the orientation of acquirers. This lack of uniformity increases the need for the structures identified in Recommendation II.

Given the differences between agreements and the speed with which they were processed, we believe an internal review of terms included in 1988 agreements would generate two significant benefits:

(1) The interrelationship of assistance terms, spreads, reporting requirements, tax benefits, approval timeframes, asset repurchase abilities, gain sharing formulas, etc. of any one agreement may not be optimum. A critical review of each transaction would yield a prioritized list of terms which the FSLIC would desire to strengthen, and also terms which it would not object to modifying to the acquirers advantage. As in any long-term partnership, the relationship and assistance agreement will evolve over time, and this review will give the FSLIC the

ability to influence, to its benefit, the evolutionary process. For example, this review might suggest that several of the earlier transactions do not sufficiently incent acquirers to dispose of covered assets due to the structure of the gain-sharing formula, and actually motivate holding covered assets through the yield maintenance spread formula. Having learned this, the FSLIC would be in a position to renegotiate these terms to the mutual benefit of both parties. It should be noted that there is an ongoing project to develop a matrix of Assistance Agreement terms, and that the first eighteen agreements have been reviewed and plotted. This project should be continued and the results thereof provided to Southwest Plan negotiators. We would expect this to have a positive impact on future negotiations and Assistance Agreements.

(2) Much was learned, no doubt, during 1988 as the SWP progressed. A critical, reflective analysis at this point will congeal the product of this learning curve from all departments and people involved, and will provide the foundation for improved efficiency, negotiating strength and consistency as the FSLIC continues in 1989 to authoritatively deal with its case load. We would recommend that in the process of this analysis, the FSLIC should evaluate the mix of capital, management expertise and long-term interest in the industry which was achieved in the 1988 agreements, with the purpose of determining ways to optimize each of these in future transactions.

V. THE FREEDOM TO REPURCHASE COVERED ASSETS MUST BE MAXIMIZED AND EXERCISED

We have previously indicated that the management and disposition of covered assets represents the single, most significant element of the eventual cost of the SWP. Additionally, based upon the condition of covered assets, the strength in the southwest real estate market, the gain sharing formula in place, the yield spread level agreed to and the tax benefit sharing agreement, the financial motivations of the FSLIC (to reduce the level of yield maintenance notes) and the acquirer (to maintain the notes) may be disparate. If, however, the FSLIC has the freedom within the assistance agreement to repurchase covered assets which it does have in most cases (and has the cash to accomplish this), it holds the ultimate ability to minimize the eventual cost of the plan and maintain discipline in the behavior of its private sector partners. In addition to the motivation this capability provides to acquirers to dispose of covered assets, if additional sources of cash become available at a cost below that being paid on the notes, this repurchase option represents an arbitrage opportunity.

We understand that several assistance agreements establish limits on FSLIC's annual ability to repurchase, and can understand the need for some level of stability on the part of acquirers. However, blanket protections should be avoided since they alleviate one partner's ability to operate on an equal basis with the other. With blanket protection, the acquirer is free to behave in his sole interest, which may be significantly different than that of the FSLIC.

Examples of several other ongoing benefits to maintaining repurchase freedom are:

(1) As SWP transactions become known and the regional situation stabilizes, certain institutions may become anxious to manage covered assets at spreads well below those in existence within certain agreements. The repurchase capacity gives the FSLIC the freedom to move these assets to the lowest bidder, and thus reduce its carrying cost.

(2) As time passes, certain institutions will prove themselves to be more aggressive and successful at disposing of covered assets and obtaining the best recapture of value for the FSLIC. These institutions should be further encouraged by having covered assets transferred to them from institutions judged to be doing an unacceptable job.

(3) It may prove beneficial to separate covered assets into groups with common characteristics such as geography, property type, stage of development, etc, and transfer assets among institutions based upon their specific areas of expertise.

It was previously suggested that the first six months of each assistance agreement will establish the expected, and accepted working relationship. Particularly during this period, the FSLIC should examine each acquirer's compliance with both the letter and spirit of its assistance agreement and take swift, aggressive and decisive enforcement or punitive action against any acquirer that is not diligently working to return maximum value to the FSLIC. Such action against one or two recalcitrant acquirers will have a ripple effect, and send a clear message to the balance of the acquirers that it is in their best interest to be attentive to FSLIC's interests.

VI. SHARING TAX BENEFITS CAN LOWER FSLIC's COSTS

The comparison of the cost of each assistance agreement with the cost of liquidation should include the estimated foregone tax collections of the Treasury in order to properly compare liquidation to the government's cost of assistance. Accepting this, we assume that Congress, in granting FSLIC assistance tax-free status, is supportive of the use of tax benefits as a means to leverage the limited resources of the FSLIC in resolving cases. This does not necessarily mean, however, that the best use of these benefits is to retain them 100% by the FSLIC. As expressed earlier, the partnership concept which supports the SWP dictates that the partners share common interests. We believe that a percentage sharing of tax benefits with the acquiring institution motivates it to organize its tax position in a manner that will maximize the use of tax benefits, and, therefore, maximize the value of these benefits to the FSLIC. As established in Recommendation IV, the FSLIC's internal review of 1988 agreements may reveal opportunities to provide a sharing of tax benefits on transactions where 100% was reserved for the FSLIC, in return for improving its financial position in another area of the agreement, such as removing asset repurchase lock-outs.

VII. THE FSLIC MUST HAVE ACCESS TO SIGNIFICANT SOURCES OF CASH

The paucity of cash available to the FSLIC acted as a major force in shaping the structure of the SWP design. This factor, together with the lack of full faith and credit, weakened the FSLIC's negotiating power with potential acquirers and eliminated many transaction structures that might have been superior to those adopted. Through the asset repurchase mechanism, transactions already done can be improved if significant new sources of cash become available, and clearly forthcoming negotiations will be more successful. The FSLIC must always have the capability to liquidate in order to maximize its flexibility.

We appreciate the opportunity to have participated in this project, and hope that our recommendations will prove to be beneficial to the FSLIC and to its implementation and monitoring of the Southwest Plan.

Senator **Wirth**. Fine. Thank you very much, Mr. Chairman.

Mr. Martin, I appreciate your comments on the real estate markets. I think we will have some very real problems in some of these areas if we don't have long-term workouts. I appreciate your sensitivity to that and those of us in areas that are a little more fragile than others are particularly sensitive to your comment and agree with you that we have to be careful and that this is going to have to be a long-term commitment. I appreciate your comments.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Wirth.

Senator Bond.

Senator **Bond**. Thank you, Mr. Chairman.

Mr. Wall, I'd be interested in your assessment of the fairness of the three basis point differential between bank and thrift insurance premiums. Is it fair? Will it cause a problem?

FAIRNESS OF THE THREE BASIS POINT DIFFERENTIAL

Mr. **Wall**. You mean at the end of the 5 year period?

Senator **Bond**. Yes.

Mr. **Wall**. It seems to me that creating premium levels by statute is a very strong action. It seems to me, more authority to bring it completely into balance ought to be given to the regulators. In 5 years hence that would seem to be the appropriate course of action. The competitive relationship is one that is very tough, very tenacious, between the two industries.

Over the years there have oftentimes been differences between one industry and another as to what they have paid in their premiums. I think it clearly is much more a focus on the depositing public's part and there should be more flexibility provided in the law, rather than to mandate in statute what the level would be.

Mr. **White**. Senator, can I add to that? This reinforces the point I made earlier. If we had risk-based premiums, we could start getting away from this kind of artificial differential. Thrifts and banks that pose equal risk, or equal lack of risk, to the fund ought to be charged equally, and it strikes me that a risk-based approach on both sides—both the bank and the thrift side—would eliminate a lot of the problems you just described.

Senator **Bond**. You said fund and I assume you mean funds.

Mr. **White**. Correct.

Senator **Bond**. Well, let me ask another question I've raised several other times. Danny, as we look at the discretion to raise the insurance premium up to 35 basis points, I have heard people comment that this is going to be a potentially negative factor in investors bidding for an insolvent thrift. If you are looking at a thrift which you're trying to figure out how you can work it out at 23 basis point premiums if there's a chance it goes to 35 basis points. Does this make your portfolio less marketable? Does this cause you some problems?

Mr. **Wall**. Well, you have a kind of perversion. May I refer back to what I said about limiting or reducing that Texas premium—you have a similar situation. The extent to which more resources put the overall industry into a more reasonable and more responsible competitive environment, you're better off. On the other hand, it is clear as an investor you would be looking at how long you have to pay that higher level, what are the prospects of it coming down, and will it come down to the same level. So as an investor you would have to be making judgments as to how much can you squeeze down the cost of doing business, how much can you squeeze down the cost of funds. On the other hand, you're going to have to pay a higher premium.

There are benefits. There are reasons why a thrift charter is attractive. Currently a very short list of entities may own a bank—an individual, another bank or a bank holding company. No one else can own a bank. No other kind of entity. Whereas, any kind of an entity or any kind of a company may own a thrift, providing they meet the criteria in terms of management and capital.

Senator BOND. In short, you're not troubled by the potential that the premiums could go to 35 basis points?

Mr. WALL. Well, it would be the same potential on the commercial bank side as well.

Senator BOND. You're trying to sell a bunch of dogs.

Mr. WALL. There are ways of cutting down the costs. You have to assess what is the difference. How much can the cost be cut down. I can't tell you off the top of my head how much that might be vis-a-vis what that additional cost is.

Mr. WHITE. Senator, I'll differ a little bit from Chairman Wall here. I think it's terrifically important that the extent of the thrift industry's contribution be made clear, on once and for all basis, so that the capital markets can absorb this information. And then they can get on with their business, which is raising capital for the thrift industry. If there continues to be substantial uncertainty as to the required contribution by the healthy part of the thrift industry, this is going to continue to cast a pall over both the ability of the FDIC—if that's the way the legislation goes—to dispose of the insolvent thrifts, as well as a pall over the ability of the healthy part of the thrift industry to raise the capital that it is being asked to raise.

So I think that trying to eliminate as much uncertainty as possible is very important.

Mr. WALL. I agree with Larry.

Senator BOND. I would disagree with Mr. Martin that we're going to change the tax laws to encourage real estate investment again. We've go too many tax built empty mausoleums in Texas and some Missouri thrifts have a little bit of interest in those as well. So I don't think that's going to happen. But I am concerned about how we deal with all of this real estate and would appreciate any guidance you could give us. What are your views on disposing of the repossessed assets at once versus holding them in the hope that the market can recover?

Mr. WALL. In terms of the contracts, providing yield or loss coverage is a way to make it economically possible for the acquirers to hold that asset and to manage it to a better price. We benefit from a better price, and they benefit from a better price. But hold forever, no. One of the consultants that Senator Wirth was referring to gave us one very sage piece of advice. He's a real estate expert of the highest order, not in the industry—not in the thrift industry.

He's an investment banker. He said the two worst things you can do with assets is dump and sell nothing. The point is you've got to deal with the in between cases. You've got to manage to sell and manage to utilize and manage to get a return. That's the challenge.

Mr. **Martin**. Senator, I do want to comment on the real estate situation. Basically, we probably have dealt with 50 or 60 percent of the savings and loan problem. Yet we already have over $71 billion worth of covered assets.

First of all, if we start to dump those for 25 cents on the dollar, we're going to take down all the healthy institutions. And it goes on and on whether it involves HUD, VA or whatever the case may be.

The second thing is that as far as tax incentives, the concept that's been advanced is that we would have a window just for the REO that is held by the insured institutions. If we could stabilize that market—when you look at $14 million buildings that are marked down to $4 million and they still can't be sold, then you've solved a massive problem. And we've got a $71 billion problem so far.

Senator **Bond**. Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Bond.

Senator Bryan.

Senator **Bryan**. Thank you very much, Mr. Chairman.

Mr. Wall, GAO has estimated that the Treasury lost about $8 billion as a result of the resolutions effected in 1988 and as I read your testimony on page 8 you indicate that in 1988 $3 billion of additional capital was placed into the industry as the result of FSLIC actions.

DID THE AMERICAN TAXPAYER GET A FAIR BREAK?

My question is, did the American taxpayer who's ultimately going to pick up the biggest portion of the cost, whatever plan is ultimately approved by the Congress, did the American taxpayer get a fair break?

Mr. **Wall**. Whether it's $8 billion on a cash flow basis that the GAO estimates or it's the $5.5 billion that we've estimated on a present value basis, no matter what the number is, the only way that those benefits are obtained is if the managers and the owners of those institutions manage successfully, making a profit in those institutions for the 10-year life of the contract. In the sense of the obligation of the acquirer, it's there. They have to succeed in order for that benefit to inure to them. It doesn't occur day one, and they can take their money and substitute it for their capital and leave. They have to operate that institution profitably, and they have to do so over that period of time.

In the final analysis, it seems to me that, as you said, it's clear that the taxpayers are going to have part of the obligation. In the final analysis, I am confident that the assessment will be that the taxpayers in the sense of these tax incentives that the Congress put in place—we didn't create them—will have proven their worth to the taxpayers.

Mr. **White**. Senator, let me expand on that if I might. The tax benefits from the FSLIC's perspective were another asset that was part of the package to be delivered to the acquirer. Half of the $5.5 billion present value of tax benefits, $8.5 billion stretched over 10 years—directly came back to the FSLIC through contractual arrangements.

The other half appeared to go to the acquirer in the first instance, but we believe that we got better terms on other parts of those contracts.

Now in the end, unfortunately, the taxpayer is going to have to pick up a large fraction of the overall cost of these transactions. So it doesn't seem to make a lot of sense to me to be singling out these tax benefits. It's all part of the cost of dealing with the insolvencies. It's the negative net worth. It had to come from one part of the Treasury or another part of the Treasury. Furthermore the acquirers were bringing fresh capital to the table. Thus, I think the proper way to think of the tax benefits is that they were just another part of what will be a substantial contribution by the Treasury to fill in the negative net worth holes for these insolvent institutions.

Senator **Bryan**. Mr. White or any member of the Board who might care to respond, did you feel from a historical perspective in terms of the operation of the Board that you had the ability, the authority, the policy directive to proceed by in effect giving these tax credits as part of the authority of the capital you had in terms of making these arrangements?

Mr. **Wall**. Without question, Senator. We sought the extension of the tax benefits which had been put into place by act of Congress earlier. We sought the extension of that throughout much of 1988 and it was included in the technical amendments tax bill that was passed and signed by the President on November 10 I believe. The tax writing committees had a budget number that they had to live within because, of course, this isn't a new loss to the Treasury. It's anticipated. They could do it one of two ways. They could give us a 6-month extension at 100 percent of the tax benefits, or they could give us a 12 month extension at 50 percent. So they took the latter.

But clearly they had considered it in the light of what we were doing and they had reaffirmed at a 50 percent level beginning January 1 of this year. But that was a budget consideration as we read it, not a policy consideration.

Mr. **White**. Senator, those tax provisions were passed by the Congress in 1981. They were renewed in 1986. They were renewed in modified form in 1988. We were exercising the authority given to us by the Congress and I believe we acted in a responsible way—in a way that in the end saved the U.S. Government substantial sums of money.

Mr. **Wall**. I think that's a very real point. In 1988 we had a limited basket of resources, as has been said by many here this morning. We had a very limited basket of resources, and this is one that we had. By utilizing this basket of resources as part of our overall arsenal, we were able to bring better into control an industry problem that was going out of control at the beginning of 1988.

Senator **Bryan**. Mr. Wall, to help to dissipate at least some of the skepticism and some I suppose have characterized the suspicion that attaches to some of these decisions that were made at year end, is it public information the analysis upon which your tax people examined these estimated or projected tax breaks? Is that information available?

Mr. WALL. We provided to the Ways and Means Committee 10 days or so ago in a public hearing appearing a spread sheet—two spread sheets—one on an institution-by-institution basis as to our basic analysis—not all of the worksheets, but on the basic analysis, and another spread sheet the cash flow numbers over 10 years. So I think in a pretty complete sense we've provided it, yes.

Senator BRYAN. You've shared with us this morning that over the years this problem in terms of its dimension has been underestimated by a lot of folks and I think one of the lessons we gained from that is that in structuring this plan we ought to be basing it upon some realistic assumptions.

One of those assumptions which has come under question recently is the assumption that the FSLIC interest rate on the notes which is now 9.5 percent as I understand it will decline to 4 percent by fiscal year 1994.

My question is, would you advise this committee, based upon your experience, the role you presently exercise, to rely upon that economic assumption as being realistic?

Mr. WALL. The economic assumption in terms of the interest rate is clearly something that is beyond our purview in terms of why the number was chosen or whether it was on the basis of OMB's projections or CBO's or picked out of the air, I don't know. Clearly, your question is an appropriate one but I think misdirected.

Senator BRYAN. One last question. There's been a good bit of discussion about brokered deposits as being a major contributing problem. My question is two-fold. What authority, if any, do you presently have in terms of limitation of brokered deposits, if you do in fact agree that that's been part of the problem; and second, if there are provisions that you presently have available, are they incorporated into the draft that we have before us? If not, should they be incorporated into the draft?

Mr. WALL. Senator, we have in place a growth regulation that in a very real sense goes directly to the question of brokered deposits, and we also have pending a risk-based capital regulation that will also relate to the brokered deposits or their use by a management of an institution. In the one sense, if you are a weak institution, there are specific growth prohibitions. If, on the other hand, you are an institution that is not in that category under the existing capital requirements, all growth has to be at 6 percent. Brokered deposits are growth. And you have to have a 6 percent capital to back for that new growth.

Additionally, the proposed risk-based capital regulation would provide for explicit capital calculations on the basis of your assets or your liabilities which again would be a factor.

So there are already mechanisms in place and/or coming into place. The need to put it into explicit statutory language I don't think is there.

Mr. WHITE. Senator, let me add to what the Chairman just said. We do have a limited cap on brokered deposits for poorly capitalized thrifts already in place. It is limited. But I would echo what the Chairman just said. I think that a focus on brokered deposits is entirely the wrong focus. Thrifts get into trouble because of what they do with their funds, where and how they invest their money; not where and how they gather their money. The whole focus on brokered funds took place 5 and 6 years ago when the Bank Board had inadequate regulatory control over where and how a thrift invested its money. There was inadequate control over growth, inadequate control over direct equity investments, inadequate net worth requirements that would require that a thrift place more of its own money at stake.

We now have those direct regulatory controls over where and how a thrift invests its money, where and how it loans its money. A focus on where and how it gathers its money is looking at the wrong side of the balance sheet. It's looking at the liabilities. Thrifts get into trouble because they make crummy loans, not because they gather their deposits in one place or another.

Mr. WALL. The only time on an industry basis that the deposit side caused a problem—in the sense of whether or not the deposits would be there as opposed to the asset side causing the problem—was in the interest rate spread period and the disintermediation that occurred in the late 1970's. Then clearly your deposit side was a problem, but it was a problem only to the extent to which it was linked to your liability side even in that case.

Senator BRYAN. Well, my time is up but I'm gathering that your conclusion is that you don't believe that brokered deposits are a part of the problem.

Mr. WHITE. Not anymore.

Mr. WALL. That's not what I'm saying at all. We're saying that in response to your question——

Senator BRYAN. I think I heard two answers at once.

Mr. WALL. We're saying that, in the sense of brokered deposits being seen as a part of the problem, we have more than enough controls in place; but what the controls affect are not the brokered funds but what you use the money for. So only in a secondary sense they're a problem.

Senator BRYAN. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Kassebaum has joined us and Senator Heinz is next in the questioning order, but would you like to make an opening comment, Senator Kassebaum?

Senator KASSEBAUM. No, thank you.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

Danny, in your testimony on pages 3 to 9 you present your latest estimate of the cost to resolve both insolvent and marginal thrifts in the industry and you indicate it will cost about $38 billion to fund the cases handled in 1988, and another $38 billion to deal with those thrifts that have yet to be resolved.

As you can well appreciate, we would like to fund this problem once and for all but the costs have been, as has been pointed out, a moving target, not just for you but for lots of other people. And what we once thought was once just simply a large but determinant hole now seems to be a bottomless pit.

In your testimony you point out many of the problems involved in estimating those costs part of the problem has been, for example, reliance on historical financial information. Another part of the problem is that the market value of thrift assets have been unknown or changed over time.

When Alan Greenspan was before the committee last week, he warned the committee that with respect to these estimates that there is much "that is unknown and unknowable." He recommended that Congress provide funds sufficient to cover the problem as we know it now but with the expectation that more funds may be needed later as more facts become known.

Do you agree with his approach? And would you tell us, if you do, in particular what facts remain unknown and what facts are unknowable?

SOME ESTIMATES ARE UNKNOWN AND UNKNOWABLE

Mr. WALL. Well, the latter case that he—better than I—can identify the problem. No one has any idea what the interest rates will be. Certainly he doesn't, and to the extent he doesn't, we don't. Interest rates are important in terms of the direct cost to an institution, in terms of getting its deposits, in terms of what they're able to get in making the loans or making other asset investments, in terms of what the interest rates might do to the value of the real estate market that's out there that, as you said, has deterioriated in some parts of the country in a spiraling way. So clearly the interest rate scenario is on uncertainty in a very real sense.

What or when the recovery might occur in a broad sense, say in the State of Texas or in a more narrow sense in specific markets in the State of Texas, is also uncertain. The view is clearly that Houston is on the rebound, that Dallas is coming back, that San Antonio is coming back. Austin may have just gotten to the bottom. So many things you don't know until after it's occurred, such as if a recovery is underway. Answers to those kinds of questions, that no one can know, are necessary in order for anyone to make an estimate.

In terms of when recovery occurs, that then affects the speed with which assets can be sold at a higher price.

Senator HEINZ. Are those the two main variables—regional recovery and interest rates?

Mr. WALL. In the broader sense, real estate recovery is key. Our industry is a real estate lender, and the real estate market is thus very much a factor. And of course the interest rates are important too.

Senator HEINZ. Mr. White or Mr. Martin, do you have anything to add to that?

Mr. WHITE. Unfortunately, the uncertainty is even greater than Chairman Wall just indicated. It's not only the timing and the extent of the recovery, but what that will do to the specific real estate parcels that are either directly FSLIC's ownership or under management on behalf of the FSLIC in the rehabilitated thrifts that we rehabilitated during 1988. So knowing what a particular parcel of real estate is going to sell for in 1995 or 1996 puts a terrific unknown into these cost estimates. We gave it our best judgment, but it has to be just that.

Mr. WALL. The timing of the availability of resources, which of course is now in your hands as the Congress in this discussion with the President, is a very, very significant part of the uncertainty. When will the resources be made available and in what form?

Mr. WHITE. The greater the delay, the greater the cost.

Senator HEINZ. On that point, let's just take a second to explore the dynamics of delay and its impact on cost. What is the difference between our actually enacting legislation in 30 days from now and enacting it in 130 days from now? What kind of difference does that make in cost if we are 100 days slower than we might otherwise be? How bad is that.

Mr. WALL. Senator, I want to say, in part, I'm reluctant to respond because it might become a self-fulfilling prophecy. Deposit outflows, as we talked about earlier, can become a cause of the problem. That can happen very fast. One hundred days could be a wink in comparison.

Senator HEINZ. What you're saying is if delay results in a failure of depositor confidence you've got a big problem.

Mr. WALL. You've got a big problem very fast.

Senator HEINZ. That is kind of obvious. But other than that one, which is a real one—I don't mean to minimize it—what are the other costs of delay here?

Mr. MARTIN. Until we get to these institutions and put them out of their misery, they will lose money. In addition to losing money, they are also costing the industry money because they're bidding up rates for savings in order to keep operational. So time is of the essence.

Mr. WHITE. To the extent that they're losing money at a rate greater than the borrowing cost of the Government to deal with the problem, that is the real economic loss. It's a loss if the operating losses are at a rate greater than the interest rate.

There is one other loss that has been overlooked. The Federal Home Loan Bank Board is now in a state of limbo. Its future is somewhat uncertain, where it's going to go. The agency's employees are feeling somewhat uncertain about their futures, although they have been promised job security. Exactly how that job security will work out is a little uncertain and creates uncertainty in their minds. And that has its consequences, not only at the personal level for them, but also in terms of their efficiency in carrying out their tasks and their ability to be able to respond to industry requests for approval of mergers, and of various kinds of applications. It does have its cost in that dimension as well.

Senator HEINZ. Mr. Chairman, there are some other questions I'd like to submit in writing for the record.

The CHAIRMAN. Very well. We will ask that they be responded to for the record.

Senator Graham of Florida.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Chairman, as I indicated in my opening statement I am concerned about the position that Congress was put in last year relative to your assessment of the state of the industry and I'm going to ask a question very directly and bluntly.

Were there any influences on you to report to the Congress anything other than your personally held best assessment of the condition of the industry, the condition of the insurance fund, and the position of the Home Loan Bank Board to effectively manage circumstances as you saw them to exist in May, September, and October 1988?

Mr. **Wall**. Absolutely not, Senator, none.

Senator **Graham**. I appreciate the directness of that response.

Therefore, are there any items in the administration's proposal or items that you would suggest should be modified or added to the administration proposal which would put yourself or a person in a similar position in the future in a better position to be able to advise the Congress as to the reality of the condition of the industry?

Mr. **Wall**. The extent to which the entity, whatever it's to be called and wherever it's to be located, is either independent or has independence is going to be the key to the answer to that question. And it's in your hands.

Senator **Graham**. In terms of information which was available to you, would there be any changes that you would recommend should be made in either data or capacity to analyze data that would increase the likelihood that future assessments of the state of the fund of the industry and the need for public policy response would be more in keeping with reality?

CHANGES FOR MORE ACCURATE INFORMATION AND ANALYSIS

Mr. **Wall**. I think, Senator, given what we have continued to be confronted with—that is, in light of what's occurred—people have been more and more skeptical as you've indicated. And that's a fair assessment for some people to make.

In response to that we have made changes. There are personnel changes in the district banks and on their staffs where we have encountered inaccurate or insufficient data. So we have made those changes. In a programmatic sense or a structural sense, no, I don't see there's a change that's necessary. There was in some sense—and I don't mean to overstate this—breakdowns in terms of their having the highest caliber of individuals involved or having the best quality of data. We thought on the one hand we had the highest quality. We had good reasons to believe that. That has not proven to have been the case. Plus how can any one evaluate a real estate market that, by the time you finish an appraisal, it's worth less than when you first looked at it? That's what was occurring in Texas in early 1988. They couldn't appraise the properties fast enough, much less find a market to which to make a comparable in order to stay up with what the market was doing in the State of Texas.

Now that is no longer the case, but as that was occurring, it was of such magnitude that no one could stay with it. The players who were there literally there day in and day out on the private side, much less our people could not keep up. And is also true for the accounting profession and for the management of the institutions. So those things are there, but in a systems sense I don't see there's a structural change to be made.

Mr. **Martin**. There is a very important number in regard to Texas that I think is very interesting. When we started to work on Texas under what we called the Southwest plan, the Texas experts were telling us that there were 97 institutions that would become insolvent out of the 282. Right now it appears that 211 of the 282 institutions will be insolvent.

Mr. WALL. And that is about a year ago.

Senator GRAHAM. You indicated that you felt the key was independence of the Board in its ability to give its most candid assessment of the situation.

Other than the personnel and information gaps that you have alluded to, were there any restraints on your independence in 1988 which affected your ability to advise?

Mr. WALL. No. Now, what I am referring to obviously is how the decisions may be made in the legislation.

Senator GRAHAM. Based on that, underscoring the importance of independence, would you like to elaborate on your answer to the question relative to whether the long-term interest of the Home Loan Bank Board would be better served by its current position, by a position of enhanced independence, or being positioned under the Department of the Treasury?

Mr. WALL. I think in the answer to the three options you suggested, two of them are clearly acceptable. One is the current status, or two, enhanced independence. The third is under Treasury. As to how it is characterized will depend on how the legislative language is provided so as to provide independence within the Treasury bureaucratic structure.

Senator GRAHAM. Have you commented on the specific language that is in the administration's draft?

Mr. WALL. We have commented on it in a topical sense here, and the extent to which more is desired in a more technical sense, we would be happy to do it.

Senator GRAHAM. I would appreciate it if you could give us a detailed assessment of that in the context of——

Mr. WALL. As to how to preserve that, yes.

Senator GRAHAM [continuing]. The answer that you have just given.

Mr. WALL. Thank you.

The CHAIRMAN. Yes, I would make that request on behalf of the committee at Senator Graham's initiation, but I think it is very important that you be asked to give us in writing an independent detailed set of suggestions or thoughts as to where you think adjustments or modifications in the plan ought to take place.

[The material referred to follows:]

Federal Home Loan Bank Board
OFFICE OF THE CHAIRMAN

M. DANNY WALL, Chairman

1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

May 24, 1989

The Honorable Donald Riegle
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Chairman Riegle:

Enclosed is information requested by Senator Bob Graham at the March 1, 1989 Hearing on Problems of the Federal Savings and Loan Insurance Corporation regarding the legislative language for our independence from the Treasury.

If you need further information, please do not hesitate to contact me.

Sincerely,

L. Arlen Withers
Director
Office of Congressional Relations

Enclosure

Treasury-related Amendments

1. The bill provides for the general oversight and direction of the Secretary of the Treasury over Federal Home Loan Bank System and the Federal Home Loan Banks. This amendment would exempt from the general oversight and direction the offices of the Federal Home Loan Banks that engage only in credit-related or correspondent banking activities.

2. This amendment would prohibit the Secretary of the Treasury from intervening with respect to particular cases or particular examinations or enforcement actions.

3. This amendment would exempt the Federal Home Loan Bank System and the Federal Home Loan Banks from the requirement that Congressional testimony and proposed legislation be cleared by the Secretary of the Treasury before going to Congress to the extent that such testimony or legislation concerned the credit-related or correspondent banking functions of these entities.

4. This amendment would exempt the Federal Home Loan Bank System from the Treasury and OMB approval process with regard to the number and compensation of employees. In addition, attorneys of the Federal Home Loan Bank System would report directly to the Chairman.

5. This amendment would exempt the Federal Home Loan Bank System's internal administration regulations from review by the Secretary of the Treasury.

6. This amendment would exempt the credit-related and correspondent banking activities of Federal Home Loan Banks which are required by statute to obtain a GAO audit, from an additional audit and investigation by the Inspector General of the Department of the Treasury.

7. This amendment would make technical changes to clarify definitions used in amendments #1 and #2.

FDIC-related Amendments to Apprcach Parity with other Federal Bank Regulators

1. This amendment would revise the FDIC's authority to take enforcement actions against savings associations. First, the amendment would delete the FDIC's authority to preempt the Federal Home Loan Bank System's enforcement authority by taking an enforcement action against a savings association in exigent circumstances. Second, this amendment would extend the time period in which the FHLBS may act when the FSLIC recommends a enforcement

action from 60 to 180 days. Finally, this amendment would limit the action the FDIC may take at the end of the 180 - day period to insurance revocation.

2. The bill gives the FDIC several different grants of rulemaking authority. One of them, section 402(d), gives the FDIC very broad rulemaking and enforcement authority over savings associations. This particular provision, which may be the result of drafting oversight, should be deleted and the FDIC should rely on its insurance fund related rulemaking authority.

3. This amendment would delete the FDIC's authority to regulate state chartered savings associations and would eliminate its role in the regulation of subsidiaries of savings associations.

4. This amendment would remove provisions in the bill that would require the FDIC's prior approval for the establishment of branches and the redemption of stock or certain debt instruments by state chartered savings associations.

5. This amendment would give the Federal Home Loan Bank System parallel chartering authority for federal savings associations as is provided to the Comptroller of the Currency for national banks.

Treasury-related Amendment #1

On page 188, between lines 19 and 20, insert the following:

"(i) Notwithstanding subsection (a) of this section and 31 U.S.C. 307a, the Secretary's oversight and direction of the Chairman and the Federal Home Loan Banks shall extend only to the System and those offices of the Banks, including joint offices, that engage in the examination or supervision of savings associations as defined in section 2(c) of the Home Owners' Loan Act of 1933, and shall not, directly or indirectly, extend to any office or joint office that is engaged solely in credit-related or correspondent banking activities authorized under this Act.".

Treasury-related Amendment #2

On page 188, between lines 19 and 20, insert the following:

"(j) Notwithstanding subsection (a) of this section and 31 U.S.C 307a, the Secretary of the Treasury shall not, directly or through the Chairman, exercise oversight, direction, or control over the issuance, grant, denial or modification of any notice, application, order, adjudication or other particular matter or the initiation or the conduct of any examination or enforcement action.".

Treasury-related Amendment #3

On page 198, lines 13 through 14, delete everything after "(12 U.S.C. 250)" and insert in lieu thereof "to replace "Federal Home Loan Bank Board" with "Federal Home Loan Bank System, with respect to credit related and correspondent banking functions of the Federal Home Loan Banks and the Federal Home Loan Bank System".".

Treasury-related Amendment #4

On page 186:

a. on lines 17 through 18, delete the phrase "Subject to the approval of the Secretary of the Treasury," and insert in lieu thereof "Notwithstanding subsection (a) of this section, section 301(f)(1) of Title 31, United States Code, or any other provision of law,"; and

b. on line 19, insert after the word "compensation" the following: "and number".

Treasury-related Amendment #5

On page 186, line 3, insert, before the period, the following:

"provided however that the the authority to issue rules, regulations and orders for the internal administration of the System shall not be subject to such general direction or oversight under this subsection or 31 U.S.C. 307a.".

Treasury-related Amendment #6

On page 203, between lines 15 and 16, insert the following new section:

"SEC. 719. Amendment to Inspector General Act. -- The Inspector General Act of 1978 (5 U.S.C. App.) is hereby amended as follows:

"(1) Subsection (b) of Section 8C is amended by adding after words "Bureau of Alcohol, Tobacco and Firearms" in the first sentence thereof, the following: "the Office of Inspector General of the Federal Home Loan Bank System";

(2) Subsection (c) of Section 8C is amended by adding before the period at the end thereof the following: "except that the Inspector General shall not initiate or conduct any audit or investigation of the credit related or correspondent banking activities of the Federal Home Loan Banks."; and

(3) Subsection (a) of section 8E is amended by deleting from subparagraph (2), thereof the term "Federal Home Loan Bank Board".".".

Treasury-related Amendment #7

On page 184:

a. on line 18, insert after "DEFINITIONS.-" the following:

"(a) Amend section 2(1) of the Federal Home Loan Bank Act (12 U.S.C. 1422(1)) to read as follows:

"(1) The term "System" means the bureau in the Department of the Treasury created by section 17(a) of the Act headed by the Chairman of the Federal Home Loan Bank System and does not include the individual Federal Home Loan Banks or any joint offices thereof.".

"(b) Amend section 2(2) of the Federal Home Loan Bank Act (12 U.S.C. 1422(2)) to read as follows:

"(2) The term "Federal Home Loan Bank means a bank established by the Chairman under authority of this Act; the term "Banks" means the twelve Federal Home Loan Banks collectively, and does not include the "System" as defined in section 2(1).".

"(c) Amend section 2(4) of the Federal Home Loan Bank Act (12 U.S.C. 1422(4)) to delete "(except when used in reference to a member of the board)"."; and

b. redesignate subsections (a) through (c) as (d) through (f), respectively.

FDIC-related Amendment #1

1. On page 230:

a. on line 3, substitute "180" for "sixty";

b. on line 5, delete the phrase "take such action" and insert in lieu thereof "consider termination of the insured status of the saving association"; and

c. on lines 8 through 17, delete from "or" to "above".

2. On page 231, line 5, delete the phrase "initiate an enforcement action" and insert in lieu thereof "recommend that an enforcement action be initiated".

Explanation

The above amendments accomplish three things. First, the authority of the FDIC to take FHLBS-enforcement action directly against a thrift institution in exigent circumstances is deleted. Second, the time period during which the FHLBS may act upon a request for enforcement action from the FDIC is lengthened from sixty days to one hundred and eighty days, a much more realistic period of time. Third, the amendments limit the remedy of the FDIC in FHLBS supervised institutions to the same remedy currently available when dealing with national banks, termination of insurance.

The purpose of these amendments is to bring the relationship between the FHLBS and the FDIC closer to the relationship the FDIC has with the other Federal banking agencies. Currently, if one of the other federal banking agencies, as primary regulator, has not resolved a substantial problem that the FDIC concludes presents a serious risk to the insurance fund, the FDIC may initiate termination of insurance procedures, but may not supercede the primary regulator's authority to conduct other supervisory or enforcement activities. The amendments preserve the FDIC's special concern over savings associations by providing for a formal process of recommendation from the FDIC Board of Directors to the FHLBS that enforcement action be taken. However, if the FDIC is dissatisfied with the FHLBS' action or plan for action, the FDIC may pursue only that action it may take with a national bank or federal member bank -- termination of insurance.

These amendments clearly place the charge for enforcement of FHLBS rules, regulations and authorities with the FHLBS consistent with section 8 of the FDIA that places pursuit of enforcement actions with the appropriate Federal banking agency. The FDIC does not have a statutory basis for pursuit of enforcement actions against savings associations in section 8 of the FDIA. Retention of this provision without the above amendments unnecessarily muddies the question of jurisdiction for both the FHLBS and the FDIC.

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FDIC-related Amendment #2

On page 133, delete lines 17-21.

Explanation

It would appear that inclusion of this general rulemaking and enforcement provision in the transitional title of the FIRRE Act was in error. The regulatory authority it would grant to the FDIC is inconsistent with other portions of the legislation (section 218) which would also give the FDIC different rulemaking authority over savings associations.

However, if this provision was, in fact, intended, then it should be deleted because it is inconsistent with the FHLBS's defined role as primary federal regulator of savings associations and the FHLBS' mandate to ensure the safe and sound operation of insured savings associations. This section is also inconsistent with the proposed enforcement provisions of section 8 of the FDI Act that would grant primary enforcement authority over savings associations to the FHLBS. Accordingly, the unprecedented grant of authority to the FDIC contained in section 402(d), for which no parallel exists in the current regulatory scheme for national banks and member banks, would overlap and interfere with the ability of the FHLBS to function as the primary federal regulator of all savings associations.

FDIC-related Amendment #3

1. Beginning on page 102, delete everything from line 13 through page 106, line 16.

2. On page 131, between line 22 and 23, insert the following new section 322:

"SEC. 322. ACTIVITIES OF SAVINGS ASSOCIATIONS AND THEIR SUBSIDIARIES. -- The Home Owners' Loan Act of 1933, as amended, is hereby amended by adding a new section 13 to read as follows:

"SEC. 13. ACTIVITIES OF SAVINGS ASSOCIATIONS SUBSIDIARIES. --

"(a) PROCEDURES. -- Whenever a savings association establishes or acquires control of a company or whenever a savings association elects to conduct any new activity through a company that the insured institution controls, the savings association:

"(1) shall notify the Federal Home Loan Bank System not less than thirty days prior to the establishment, or acquisition, of any such new company, and not less than thirty days prior to the commencement of any such activity, and in either case shall provide at that time such information as the System may require; and

"(2) shall commence and conduct the activities of the company in accordance with such rules, regulations and orders as may be established by the Federal Home Loan Bank System.

"(b) ENFORCEMENT POWERS. -- With respect to any company controlled by a savings association, the Federal Home Loan Bank Board System shall have authority to determine, after notice and opportunity for hearing, that the continuation by the insured savings association of its ownership or control of, or its relationship to, the company constitutes a serious risk to the financial safety, soundness or stability of the savings association is inconsistent with sound banking principles or with the purposes of this Act, and upon making any such determination the System shall have authority to order the savings association to divest itself of control of the company; the Federal Home Loan Bank System shall also have the authority to take any other corrective measures with respect to the company, including, but not limited to, the authority to prohibit the company from commencing

> the activities or operations posing such risks or to have the company terminate such activities or operations, as the System may deem appropriate.".".

Explanation

Section 218 of the bill would give the FDIC the authority to regulate the activities directly conducted by State-chartered members of the Savings Association Insurance Fund. Because the FDIC does not currently possess this power with respect to national banks and member banks, the current version of section 218(5) would grant to the FDIC an unequal authority over savings associations. This amendment would delete this authority for the FDIC.

This amendment would also amend the Home Owners' Loan Act to clarify the Federal Home Loan Bank System's authority to regulate the activities of subsidiaries of federal and state-chartered savings associations. This amendment is appropriate in that the FHLBS should regulate the subsidiaries of the entities for which it is the primary bank regulator.

FDIC-related Amendment #4

1. On page 101, delete lines 14-17.

2. On page 101, delete lines 18-24, and on page 102, delete lines 1-12.

Explanation

The bill would give the FDIC approval authority over establishment of branches and redemptions of stock or certain debt instruments by savings associations. This provision must be erroneous as such approval authority should be vested in the Federal Home Loan Bank System, which is the primary federal regulator of savings associations. Moreover, the authority that the FDIC would possess under these provisions is inconsistent with its authority with respect to the same actions if taken by a national bank or member bank. Accordingly, because these provisions of section 18 of the FDI Act relate solely to the FDIC's role as appropriate Federal banking agency, their coverage should not be extended to savings associations for which the FHLBS will be the appropriate Federal banking agency and, as such, will serve as primary regulator.

The proposed deletion of section 218(4)(b) is appropriate due to the fact that, under the FIRRE Act, the FHLBS would already have the authority to set capital levels of State as well as Federal savings associations. The additional granted in this proposed section is therefore unnecessary.

FDIC-related Amendment #5

1. On page 15, line 8: Following line 7, insert a new subsection (2) as follows:

"(2) subsection (b) is amended --

(a) by inserting after the phrase 'other than trust funds as herein defined' the second time it appears: 'and every Federal savings association which is authorized to engage in the business of receiving deposits, other than trust funds as herein defined,';".

2. On page 15, line 8: Delete the phrase "(2) subsection (b) is amended" and insert in lieu thereof "(b)".

3. On page 15, line 19: Following line 18, insert new paragraphs (c), (d) and (e) as follows:

"(c) by deleting the word 'or' in the second sentence of subsection (b) and inserting after the phrase 'in the case of such State member bank' the following:

', or by the Federal Home Loan Bank System in the case of such Federal savings association';"

"(d) by deleting the word 'or' following the phrase 'admitted to membership in the Federal Reserve System' and inserting a comma in lieu thereof, by inserting after the phrase 'converted into a national member bank' the phrase 'or an insured savings association which converted into a federal savings association', and in the phrase 'the bank shall continue as an insured bank', by changing the word 'bank' to 'financial institution'; and"

"(e) by changing the word 'bank' in the third sentence of subsection (b) to 'financial institution', deleting the word 'or', and inserting after the phrase 'in the case of a State member bank' the following:

'or is authorized to engage in the business of receiving deposits in the case of a Federal savings association'."

4. On page 16, lines 10-25, page 17, lines 1-19: Delete subsection (1).

5. On page 17, lines 20 and 24, page 18, lines 6 and 13: Redesignate subsections (2) through (5) as subsections (1) through (4).

Explanation

These proposed amendments to sections 204 and 205 of the FIRRE Act would eliminate the separate insurance application procedures for Federal savings associations contained in section 205 and would make Federally-chartered thrifts subject to the same procedures in section 204 currently followed by national banks and State member banks.

Under current law, banks that are authorized to commence business as national banks or that become members of the Federal Reserve System ("FRS") automatically obtain FDIC insurance of accounts at the same time that they receive a national bank charter from the Comptroller or FRS membership from the Federal Reserve Board. This procedure would be essentially retained in the FIRRE Act; however, a separate procedure for Federal savings associations would be established that would give the FDIC the ability to deny insurance of accounts for such institutions. Accordingly, the above revisions to sections 204 and 205 are necessary to provide the FHLBS with the same degree of chartering and regulatory authority over Federal savings associations as would be possessed by the Comptroller and the Federal Reserve board with respect to the financial entities for which they serve as primary Federal regulator.

The CHAIRMAN. I don't view this as being asking you to not be a team player in terms of the development of the proposal. We have asked others, like Seidman, representing the FDIC, to do precisely the same. So it would be very helpful for you to give that to us.

Mr. WALL. If I might make an observation as well. Senator Graham, following up on your comment, and we should not focus only on the question of Treasury being where independence might be lost. There clearly is the prospect of independence being lost to the FDIC. There has been an ongoing discussion and tension between the FDIC and the Fed and the Comptroller—on the one hand the regulators—as they see their responsibility and, on the other hand, as the insurer sees his.

So I think that is another area in which the independence could very well be under challenge in a legislative sense.

The CHAIRMAN. Thank you.

Senator Kassebaum.

Senator KASSEBAUM. Thank you, Mr. Chairman.

Mr. Wall, you must feel a bit, as you go through all this, a little bit like that old saying, "Other than that, Mrs. Lincoln, how did you enjoy the play?"

But I——

Mr. WALL. I use that about once a day, Senator. Thank you. [Laughter.]

BROKERED DEPOSITS

Senator KASSEBAUM. I would like to follow on with the questioning on brokered deposits a bit because I was interested in—and maybe there is not a lot more we can elaborate—but you said in your testimony that many of the most costly resolution cases had relatively heavy holdings of direct investments and brokered deposits. and while I know it seemingly from the testimony of others going to be difficult to get at the whole question of how one deals with brokered deposits and while you believe it has not been a factor, it seems to me brokered deposits do cause unstable conditions, that there is liquidity and sort of a frenetic activity that can evolve regarding brokered deposits.

And maybe back to those that have been the most difficult cases, they were in many ways small institutions, is that not correct?

Mr. WALL. All sizes, but I would——

Senator KASSEBAUM. That had enjoyed really phenomenal growth?

Mr. WALL. Oh, they had been. Oh, yes, yes.

Senator KASSEBAUM. And how did they then attract their deposits?

Mr. WALL. By paying higher rates.

Senator KASSEBAUM. And this attracted a number of these type of brokered deposits, however, did they not, in institutional deposits?

Mr. WALL. Yes, all types of deposits, yes.

Senator KASSEBAUM. So you, I think, also here—and you are very familiar with the 1984 efforts to address brokered deposits on the part of both FSLIC and FDIC—you said that in 1988, I believe, you undertook some efforts to curtail or limit brokered deposits, is that correct, FSLIC did?

Mr. WHITE. The regulation is a 1985 regulation that was passed in the wake of the court defeat of the direct effort to——

Senator KASSEBAUM. How does that differ from the efforts that were undertaken in 1984?

Mr. WHITE. My recollection—and I wasn't there at the time—is that the 1984 effort was to deny insurance to brokered deposits, whereas the 1985 regulation puts a limit on the fraction of deposits that weakly capitalized thrifts can have as part of their liability base.

Mr. WALL. It was a little bit different trigger, as my staff is reminding me. In 1984, what was going to be done was that all insurance on any one broker's deposits at an institution would be limited to the $100,000 amount. That was technically the way it was done, and it was not successful. The courts rejected that.

But I would want to come back to the point that both Larry White and I were making, and that is that the problem isn't the brokered funds per se. The problem is what they do with that money that comes in—or that came in too easily.

That was in another period. We now have capital restrictions on. You can't grow as an institution unless you have 6 percent against that new growth.

Senator KASSEBAUM. How long has that been in place?

Mr. WHITE. Since 1986, for the last 3 years.

Mr. WALL. Yes, late, December 1986.

Mr. MARTIN. Senator, I think we must be careful not to put anything into the statute about brokered deposits because there is a plus for brokered deposits. Healthy institutions use them. They could have a case where they may have a temporary need for maybe $10 or $15 million for liquidity. It is much cheaper in the long run to go to a broker than to put rates up in the marketplace and have all the rates in the area go up.

So there is a plus to broker deposits.

Senator KASSEBAUM. And I can understand that. That is why evidently this is difficult to know quite how to deal with it, where there is a positive side and yet, on the other hand, where I think in a number of cases—and you make this point—here with those that have had phenomenal growth in order to capitalize, sort of like the chicken and egg effect, to continue to get liquidity and funds rely on this and this is why I say I think it has been an unstable situation, exacerbated to a certain extent, it seems to me, by this type of——

Mr. WALL. Some of these things that we talked about in our testimony, and I discussed in my oral comments relate. Such as the matter that some of these insolvencies have been there for 10 years.

There will be these same post-mortem kinds of observations—brokered funds, equity risk investments, et cetera—but these factors were in a different time, a time without the restrictions that apply now.

Senator KASSEBAUM. Well, since you imposed the restrictions in late 1986, have you noticed a change? Has that made a difference?

Mr. WHITE. We have all of the other things that happened at the same time, the overall restrictions on growth, the equity risk investment limitations, the better capital regulations. It would be hard to sort out one factor.

Senator KASSEBAUM. Let me just ask briefly one other question before the red light goes on.

And that is sort of the basket of resources that you spoke of when you were talking about the deals that were put together.

Rather than going into all the specifics of that, there have been those who said that what we then have created to a certain extent are nationalized institutions, and do you have any worries about the competition, unfair competition, between these large entities that have been created and thrifts that are still struggling?

Mr. WALL. First, the many insolvent institutions that had already been resolved were totally our responsibility as the insurer. So we had 100 percent of the obligation, implicity or explicity.

To the extent that we have now been able to get private sector managers and their capital, a total of $3 billion worth last year, into in those institutions, we now have partners in those situations. We are not in a control situation in a day-to-day management context, but we have an upside position in the assets and an upside position in the recovery of the institution in the warrants.

In a competitive sense, those acquirer/managers have to make their institution profitable with the assistance that we give them. So they are going to be competitors with the other healthy institutions on a more equitable basis than that insolvent institution was before, without question.

Senator KASSEBAUM. But with some advantages?

Mr. WALL. No. The advantage——

Senator KASSEBAUM. In the tax?

Mr. WALL. What some people see an advantage is simply bringing to equity, bringing to a more market level. If we had had unlimited resources we would have taken out of that institution many assets that we would have liquidated over time, but we would have been the managers, the Government would have been in charge of it. I would much rather have private sector managers managing those assets for us.

In all of the grief we have taken over FADA, which I think has functioned very well, has been criticism in a sense of the Government shouldn't be in that kind of a management position. So we are leaving the private sector in the management positions in those institutions and not with an advantage.

Mr. WHITE. Senator, the right way to think about the covered assets, the capital loss coverage, the yield maintenance on those assets, is that in essence the acquirers are managing those assets on our behalf. For the remainder, the uncovered assets, the acquirers are on their own. They are competing with their neighbors across the street with respect to those uncovered, at-risk assets, if anything, the acquirers are very likely better capitalized, putting more of their own capital at risk in relation to those at-risk assets than their unassisted rival across the street.

So if anything, the acquirers are at a disadvantage as compared with their undercapitalized rivals across the street.

Mr. MARTIN. I would like to add one other thing, Senator.

The healthy thrift benefits several ways. First of all, we have been able to reduce the cost of savings. For example, in Texas we have dropped the cost of savings 25 basis points while Treasury's went up 124 basis points.

Second, in Texas we took 87 institutions and reduced it to 17. They had 867 branches, and they only have 602 today. So they had a tremendously overbanked situation in Texas and through consolidation the healthy institutions benefit.

I don't think that the acquirers disadvantage their competitors. I think they bring something to the table.

Mr. WHITE. One further point. I have been talking with and giving speeches to various representatives of the thrift industry. This is not nice to say, but their major concern at the moment is not competition from assisted FSLIC thrifts. It is from FDIC-related institutions in the State of Texas. I keep hearing these stories about incredibly high interest rates that the FDIC-assisted institutions have been offering, and that is where their major concerns about unfair competition are coming nowadays, Senator.

Senator KASSEBAUM. That has been an historic competition, I think.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Kassebaum.

Mr. WHITE. Not at the rates and the stories that I have been hearing about, Senator.

The CHAIRMAN. We have gotten into this subject, so I just want to sort of make a point on it in passing here because our focus is a forward focus. But the issue has been put on the table, and I want to just make an observation about it.

I have received what I consider to be credible information that one of the assisted December deals occurred, so I am told, by an individual's tax man going to an individual and saying, look, you had a real tax problem this year and we have been looking for a way to solve it. We think we have found it by getting you into the savings and loan business. Therefore, this particular acquirer came into the business, by virtue of the way the packages were being done secured a very large positive tax impact that will work in such a way that within a period of 12 or 18 or, at the most, 24 months in effect will have recouped all the capital put in the form of the tax savings by virtue of the way the tax angles work for that acquirer.

Now, I don't want to rehash that case because we could probably spend the rest of the day doing so. But I must tell you that if things like that in fact were happening, where we were in effect enticing people into the savings and loan business who, I would think, may not have any great long term interest in being in the savings and loan business but in fact might have been solving an unrelated tax problem, I would be very disturbed by that. I would think that would not be a sound basis upon which to make public policy.

In any event, there are stories like that that circulate—not just stories, but people who come forward and are people of consequence who purport to be close enough to the facts to relate stories of that kind.

RESPONSIBILITY FOR MAKING DEALS FOR INSOLVENT THRIFTS

Let me just ask you this. Who is responsible for any deal making that is going on today? Does the Board today handle the deal making, or has that moved over to the FDIC, or is there any deal making in the works?

Mr. WALL. There is no deal making per se for the most part. We have one particular case we are looking at—it involves two minority-owned institutions. So it is a unique situation. We are looking at that one.

Other than that, there are no deals being discussed per se. To some extent there are discussions of the prospect of deals. Chairman Seidman and I were in a discussion yesterday with representatives of two institutions that are trying to find self-help. Of course, you are in an interim kind of a period. Today our responsibility may be the FDIC's responsibility tomorrow. So we had that joint discussion.

The CHAIRMAN. So you are doing a joint——

Mr. WALL. In that case we did.

The CHAIRMAN. In the sense of operating jointly today, you would not make a deal now without the okay of the FDIC, or how is the procedure working at the moment?

Mr. WALL. In that case it was to decide whether to discuss any further with these interested institutions a self-recovery, self-recapitalization plan. There we did it together. We had the conversation together with those individuals.

In the case of the other situation I mentioned, where we are looking at the possibility of a merger of a failed minority-owned institution with another larger minority-owned institution. We are doing that one ourselves and communicating with them: What is the status of it? What we think the appropriateness is of the deal, but by no means have we decided even to move forward.

So it depends on the situation, Senator.

The CHAIRMAN. But I want to understand again the procedure. You saying that, in effect, in some situations you still see yourselves as having the responsibility.

Mr. WALL. Well, technically it is our money, and the decision will be our decision until the Congress acts. If there were a deal that we decide to move on—should we decide to move unilaterally which we wouldn't—that would be our legal authority. If the FDIC were in receipt of a proposal on an institution that is insured by us, they would have to come to us for our approval.

So it depends on who the contact is made with.

The CHAIRMAN. I see.

Well, just in terms of how things are working today, as I understood it, the President, using Executive authority, assigned the responsibility——

Mr. WALL. No.

The CHAIRMAN. He did not?

Mr. WALL. No. We, by agreement, contracted. The FSLIC with its parent, the Federal Home Loan Bank Board, contracted with the FDIC. It was not by Presidential direction.

The CHAIRMAN. I see.

Mr. **Wall**. The President asked us to consider that, did not tell us to do it. We did it by mutual agreement.

The **Chairman**. After he asked you, you decided you would?

Mr. **Wall**. The question was asked.

The **Chairman**. Probably a good decision, I would say.

Mr. **Wall**. The question was asked, and there was no suggestion that they felt they had the authority to tell us. We are both of us independent agencies.

The **Chairman**. I don't want to get hung up on that. They asked you to do it, and you decided that you would do it.

What I am concerned about now is just understanding the question. In terms of what we now call an insolvent thrift, if a deal were to be considered in that area, would that be something that you would negotiate, something the FDIC would negotiate, or is it something that you would have to do jointly and agree on jointly?

Mr. **Wall**. We would negotiate it. It would be our obligation, our responsibility, but clearly we would be counseling with them. We would be getting their advice, their observations. But it is our money. It would be our responsibility.

Mr. **White**. But basically, Senator, there is not much in the way of transactions being considered at the moment.

The **Chairman**. And if I may just ask, is that because the picture has changed?

Obviously, we don't know what the final legislative outcome will be. The tax advantages changed as of the yearend.

Do you still have acquirer groups that are waiting at the door that want to come in, and do you have a number of them?

Mr. **Wall**. We have deals that were negotiated that people would like to see carried through to completion. But as I indicated to the House Budget Committee I think during the third week in January, we were getting close to the point where we had insufficient resources. The pledge we had made time and time again was that we would not issue or create obligations beyond what we could see our ability to retire.

The **Chairman**. Well, just two things. The question as to whether there are acquirer groups standing at the door that would like to do deals, the answer is yes at the present time?

Mr. **Wall**. Yes.

The **Chairman**. But the other question is, before yielding to Senator Garn, and that is this. How much money is in the cash drawer of FSLIC today?

Mr. **Wall**. A little in excess of $1.6 billion.

The **Chairman**. And is any of that presently obligated?

Mr. **Wall**. No.

The **Chairman**. I mean, that is free money and that is your cushion?

Mr. **Wall**. That is cash. That is right.

Mr. **White**. But we do have the ongoing obligations.

Mr. **Wall**. Well, we have—that is there for future cash commitments. It is part of our cash flow projections.

The **Chairman**. And in terms of your cash flow projections, do you do them forward month by month?

Mr. **Wall**. We do them——

The **Chairman**. Week by week?

Mr. **Wall**. We have 10-year cash flow——

The **Chairman**. Well, forget 10 years. I am talking about——

Mr. **Wall**. Week by week, month by month, quarter by quarter, all the way out.

The **Chairman**. So you would have, for example, today, say, a 30-day projection of payments out, receipts in?

Mr. **Wall**. Right, yes.

The **Chairman**. And are we eating into that residual amount or not at this point that is in the cash drawer today?

Mr. **Wall**. No. No, we still have borrowing authority at FICO, that in fact we are going to the market again in an orderly way because we have these future obligations for our cash obligations under the contracts. We know when they will occur. We have an idea of how much they are going to be. So we have to have the cash available. The previous Board had said they wanted a cash balance no less than $500 million. We have said we want a cash balance available of no less than $1 billion, and we have preserved that.

The **Chairman**. I want to not go way beyond my own time period.

Senator Garn.

Mr. **White**. Senator, there is one final piece that I think is important to make clear. Basically, all transactions are on hold until the legislation is passed resolving the future of the fund. That to me is why rapid action by both Houses, rapid passage of this legislation, getting the funding authority into the FDIC, giving them the ability to be able to continue disposing of the insolvents, is terrifically important. Without that action those insolvents are going to continue to fester and to run up operating losses.

The **Chairman**. You don't have to convince the committee of that. I think the committee as a whole shares that view.

It is interesting to me, however, that you say you have got people that want to do deals right now even with the legislation up in the air.

Senator Garn.

Senator **Garn**. Thank you, Mr. Chairman.

Getting away from the issue for a moment of where the Federal Home Loan Bank Board ends up or in what form, whatever the final conclusion of the legislation is, whether it is with Treasury, independent, one member or three, you state in your testimony that the new Federal Home Loan Bank Board must be empowered to continue the task of regulating and supervising the industry.

Would you elaborate on what authority is absolutely essential for the Federal Home Loan Bank System to have to be able to solve these problems regardless of what structure it ends up in?

Mr. **Wall**. There are really three categories—being able to establish the capital requirements for the industry, the enforcement authority, and the chartering authority. In all three cases, the powers must be explicit and that we have such authority. It cannot be simply a framework where others have the real authority.

Senator **Garn**. Well, in addition, I would assume there is one more. You must be able to remain in a situation where the pay caps are off so you can retain the people.

KEEPING PAY CAPS OFF

Mr. **Wall**. Yes. That is in the bill. As I indicated earlier, I would reinforce that that needs to be provided so as to protect that structure that has been put in place, without question.

Senator **Garn**. This is one of my concerns about the Board going to Treasury. The Comptroller has not been able to keep those pay caps off and has therefore not been able to hire and retain some of the people that they would like to.

Mr. **Wall**. And it is no secret that there are significant numbers of former Comptroller of the Currency staff who make up at all levels the examination and supervision force of the Federal Home Loan Bank System, and we are glad to have them.

Senator **Garn**. An issue that has not really been discussed in the administration's proposal—and I suppose maybe we can call it a sleeper issue—is the new board structure of the Federal Home Loan Mortgage Corporation. It really has not been brought up.

Could you give me and the committee your opinion on how that Board should be structured?

Mr. **Wall**. Well, as this committee knows, the three of us also sit as the Board of the Freddie Mac, and we have the responsibility by virtue of our being Board members at the Federal Home Loan Bank Board. If the Federal Home Loan Bank Board becomes the system with one chairman and no Board as such, there would be the need to create a new Board for Freddie Mac.

The Board of Freddie Mac, the three of us, 2 weeks ago at a Board meeting put forward a compromise proposal, including private sector stockholder representation, private sector nonstockholder representation, private sector Presidential nomination representation, and the proposal that five individuals should serve on that Board by virtue of other offices.

So we have put forward a 13-member Board framework, building on the Fannie Mae, Sallie Mae, similar situations, that is not identical by any means, but a similar kind of construct.

I notice that my colleague Larry is moving to the mike. He disagrees. He believes that the structure should be 100 percent Government authorities.

Mr. **White**. Let me just expand on that a little bit.

Freddie Mac will continue to be a publicly chartered, congressionally chartered corporation that is operating with the benefit of an implicit Treasury guarantee behind its obligations. Though I believe that the current management operates that company superbly and deals very well—in a very professional fashion—with their credit risk and interest risk components, I am very concerned about future situations, future managements, future stockholder pressures to be taking excessive risk at the expense of the Treasury. That is why I believe an entirely public Board—of public officials or their designees—is the right way to thoroughly protect the Treasury against such risks.

Senator **Garn**. How about if we go in that direction, place more Government officials on the Board or make it totally Government? Doesn't that take away the possibility of privatizing Freddie Mac?

Some of us think that we should move in the direction of privatization?

Mr. **White**. Not in the least, Senator. The essence of privatizing would be to remove the Treasury backstop from prospective obligations issued by Freddie Mac—remove the implicit Treasury guarantee. The minute you do that—except for the residual guarantee that might remain over the existing obligations—you could start to unwind the Board and start placing private representatives on it.

I see no contradiction between the current situation of an implicit Treasury guarantee and a publicly appointed public official board and any future privatization of Freddie. You can then have your private board. No contradiction whatsoever.

Mr. **Wall**. I think you see why my colleague Roger Martin and I came with a compromise position. It tries to achieve some of both. It tries to achieve an additional continuing governmental relationship as well as increasingly a private sector orientation.

Senator **Garn**. Is Treasury a good regulator when you consider Freddie Mac competes against Treasury securities every day?

Mr. **Wall**. I am not sure of the question is one of being a good regulator.

Senator **Garn**. Well, what I am talking about is getting back to——

Mr. **Wall**. Is it appropriate? Would they be a threat to housing?

Senator **Garn** [continuing]. Whether it is appropriate or not to go back and put you or Freddie Mac under Treasury. This is another element we haven't discussed—the competition with Treasury securities every day when you put them under Treasury.

Mr. **Wall**. Well, the outcome of the Board we have suggested, Roger and I have suggested, for Freddie Mac has the effect of not putting them under Treasury per se. There would be some membership on that board that could be identified as Treasury and Treasury-oriented, but by no means does it put them under Treasury.

Senator **Garn**. No, and I didn't mean to indicate your proposal did. But this is one thing in the administration's proposal that is not clear to me.

Mr. **White**. Everything involves conflict at some level or another. To the extent that the Treasury is ultimately the backstop, the Treasury has to be concerned. I don't see how it can be avoided.

Senator **Garn**. Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Garn.

Senator Graham of Florida.

Senator **Graham**. Thank you, Mr. Chairman.

Mr. White, I was concerned with some statements that you made earlier relative to the competition in rates created by FDIC-assisted institutions relative to FSLIC-assisted institutions.

Currently, in Florida newspapers an ad is being run by an institution, Beach Federal, which was a FSLIC-assisted institution created at the end of 1988, which has as its headline, "Hot Rate! Short Term! $1,000 Minimum!" And it advertises for 6-month certificates at an annual yield of 9.56, which is a ½ to 1½ points above what the other institutions in the Tampa Bay region are currently paying for 6-month CD's.

Is this an aberration, and in the plan that led to the establishment of Beach Federal was any consideration given to constraint on its rates that it would pay for certificates of deposit? If so, what were they, and if not, why not?

Mr. WHITE. Well, my earlier remarks had been addressed more at Texas FDIC-insured—sorry—FDIC-assisted institutions. Board Member Martin knows a little bit more about this particular situation.

Senator GRAHAM. So you want to qualify the statement of assault on FDIC to one State?

Mr. WHITE. Well, as I thought I had said, those thrifts were in the Southwest area. The question from Senator Kassebaum had been in terms of unfair competition and was mostly focused on Southwest plan transactions. The healthy thrifts in the Southwest area weren't worried about the FSLIC-assisted competitors. It was FDIC-assisted competitors.

Mr. MARTIN. First of all, we had an understanding with the manager or the acquirer of Beach that this would not happen. Obviously, it is. We track it.

I think this is an aberration. You have a run going on in southern Florida.

Senator GRAHAM. What was the nature of the understanding that you had there?

Mr. WALL. That he could shrink the deposit base.

Mr. MARTIN. And bring rates down.

Mr. WALL. And bring rates down.

Senator GRAHAM. Was that a contractual commitment?

Mr. MARTIN. No, I don't believe we have it in a contractual agreement. I would have to check it. I doubt it. I know we had the verbal commitment because I talked to him personally when we were working the deal.

Mr. WALL. Let me come back, if I can, to something that my colleague just mentioned.

Senator GRAHAM. Excuse me, could I just finish this specific line? You had a verbal understanding that there would be a shrinkage of the institution and a lowering of rates.

Mr. MARTIN. Right.

Senator GRAHAM. That has not happened. What is your current enforcement policy relative to this breached obligation?

Mr. MARTIN. I don't think basically we can do that, but we will have a nice phone call. I call it a "Back to Jesus" meeting with him.

Senator GRAHAM. You might invite Moses and Mohammed, too.

TEASER RATES ON DEPOSITS

Mr. WALL. Senator, let me raise a point that my colleague just made, and I know that he didn't intend it as it may have sounded. We do not have a run per se. What is going on, as is in my response to Senator Riegle earlier, is that there are outflows that are occurring for lots of reasons, for the interest rate choice reasons in terms of where the interest rate curve is in as such.

But if I might come back to the issue that you raised with regard to Board Member White's comment.

You hear about teaser rates on mortgages. Someone will for a very short period of time—it might be 6 months, might be 9 months, might be 12 months—give a very favorable rate to the borrower. There are similarly today teaser rates on deposits, and the teaser rate that I believe my colleague was referring to is 15 percent for 90 days by an FDIC-insured bank in Texas.

Now, that may be an aberration, but that is troublesome.

Senator GRAHAM. Do you currently have or does the administration plan provide some ability to control activities such as Beach Federal or the FDIC institutions relating to their authority so that we won't have these conditions in the future?

Mr. WALL. I think there are—in our contracts at least. There are provisions where we have the authority to step in on the basis of various criteria, whether it be safety and soundness, whatever they might be. We have the ability to step in, and we would, and I am sure the FDIC does as well and will.

Mr. WHITE. But, Senator, I think it is important to realize these high interest rates are not an indication that Beach, which we have a lot of information about, is trying to gather money at a high rate so as to be able to go out and do wild and crazy things with it.

Clearly, that was happening back in 1983 and 1984. That is not what we are talking about today.

We are talking about liquidity problems today. When the President's program is put in place, when FDIC has the clear ability to be able to put the insolvents out of the picture, backed up by the kinds of liquidity arrangements that have been arranged with the Federal Reserve and the Federal Home Loan Bank System, we are not going to see these kinds of phenomena.

They are really short term, liquidity-related problems rather than anything involving gathering the money and doing wild things with it.

Mr. WALL. I have to add as well, the institution you have named has a management team that is among the toughest, and the clearly most highly considered, in the country in terms of their conservative nature.

Mr. WHITE. This is Beach?

Mr. WALL. That is right.

So that is really reinforcing, and then some, what Larry said about this not being money that is flowing in to be used for some crazy function.

Senator GRAHAM. But if they have those qualities, I assume they also have some qualities of integrity, and Mr. Martin just stated that they had not been fulfilling commitments that were made to him. This institution not only is affecting its own status, but it is also contributing to the adverse circumstance of many other institutions who have to compete against this carnivorous rate.

Mr. WALL. Senator, I am sure that Roger is looking forward with great glee to making the phone call in this particular case. There is no question in my mind that he is looking forward to that.

Senator GRAHAM. Well, I would like to know the consequence of that call and also what we——

Mr. WALL. You may not even have to be in the same room to hear it, I venture to say.

Senator GRAHAM [continuing]. What we can—what either you can do administratively or we can do legislatively so that that call won't have to be placed in the future.

Mr. White. But again it is basically a liquidity problem. When we did these transactions in December we had not envisioned the liquidity problems that have arisen in February. That has somewhat changed the terms of what we are looking at.

Mr. Wall. One of the problems you get when you merge 6 or 10—or in one case 15 institutions—into 1 resulting institution, Senator, is that someone may have had $100,000 in each 1 of those 15. They now have to consolidate down to one. That is an outflow to that institution of 14 units of $100,000 that has to go somewhere else.

That is the problem that is occurring on the FDIC side even more than on our side because of the structure of banks in Texas.

The Chairman. Senator Graham, Senator Garn and I are going to put the remainder of our questions in the record. So I would like you to feel free to continue if you want.

Senator Graham. One last question that touches in the general area of brokered deposits and, Mr. Chairman, I would like to put in the record a very comprehensive article that appeared in Barron's on February 27, 1989.

The Chairman. Without objection, so ordered.

[Article from Barron's follows:]

BARRON'S
February 27, 1989

Anatomy of a Mess

The True Villains Behind the S&L Crisis

By JOHN LISCIO

REMEMBER Billy Mitchell? General William Mitchell, that is: World War I ace and the first U.S. officer to fly behind enemy lines. Mitchell was the foremost champion of air power in the early 'Twenties, a man who relentlessly warned about Japanese aggression, and, on at least three occasions, himself displayed just how easily bomb-carrying aircraft could sink battleships at sea.

Billy Mitchell was a prophet without honor in his own country. Indeed, he so went against the grain of military wisdom that he ultimately was court-martialed for insubordination.

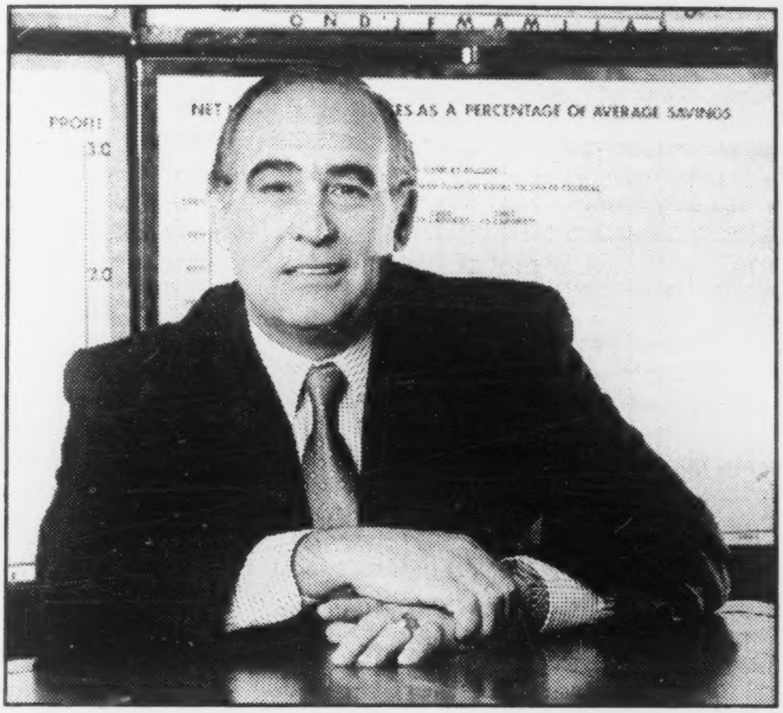
In many ways Ed Gray, former head of the Federal Home Loan Bank Board, the regulatory agency that oversees the thrift industry, is a latter-day Billy Mitchell. Though, unlike Mitchell, Gray has lived to see his dire predictions come true.

Ironically, Gray, who tirelessly if futilely sounded the alarm, now finds himself accused of dereliction of duty, of presiding over a Bank Board that was asleep at the switch while the industry highballed it down the express track to ruin.

Gray may not have been the most capable or qualified administrator, nor was he, as his critics so eagerly point out, a financial genius; he may have spent too much time traveling and making speeches, and may have been, at least in the beginning, the proverbial nice guy in over his head. But he did, time and again, warn Congress that the Ponzi scheme that had become the thrift industry would soon collapse and the Federal Savings & Loan Insurance Corp. along with it. What troubled him even more was that the taxpayer would wind up footing the bill. In numerous appearances before Congress and in speech after speech, Gray asked for more examiners, better oversight, tighter control—to no avail. In the Reagan years a regulator crying out for greater powers was viewed as a traitor to the cause.

When Ed Gray came to the Bank Board it was still an inconspicuous agency firmly under the thumb of the U.S. League of Savings Institutions, the powerful trade association of the thrift industry. As a matter of fact, the League until the 1940s had appointed the chairman of the Bank Board, and had helped draft its supervisory law in 1966, a law which actually impeded effective action against reckless management with many "due process" protections.

Ed Gray was a former journalist and press secretary to Ronald Reagan with longstanding ties to the President. Until his appointment to the post, he had been a public-relations ex-



Ed Gray

ecutive at a large California thrift. "I was never supposed to be a tough guy," Gray explains. "I was supposed to be a patsy, a cheerleader; merely an extension of the League."

When he took the helm on May 1, 1983, deregulation was the battle cry in Washington and nowhere was it resounding with more clamor than in the thrift industry. The Garn-St Germain Act had been passed overwhelmingly by Congress in 1982 to shore up the industry, which was in deep trouble because high interest rates had been driving up the cost of deposits faster than the income from long-term mortgages. The new legislation allowed thrifts greater scope in lending and allowed them to offer money-market deposit accounts free of rate controls. Around the same time, Congress lifted the maximum insured amount of any single S&L deposit to $100,000 per individual from $40,000. The Senate had voted to raise the level to just $50,000, but the powerful S&L lobby wanted the higher limit and Fernand St Germain slipped a $100,000 "compromise" into a large and complex banking bill.

"We were lucky they didn't get a million," wryly observes Tim McNamar, deputy Treasury Secretary at the time. "The thrifts were so powerful in Congress they could get anything they wanted."

The minimum net worth the thrifts were required to maintain had been reduced from 5% in '81 to 3% in '83 and, in truth even that reduced requirement was rendered somewhat meaningless by phony accounting.

De novo thrifts had 20 years to get from 0% net worth to 3%, and all institutions were allowed the benefit of five-year averaging to determine their net worth calculation, which enabled them to grow by leaps and bounds and then gather their capital behind them. Thrifts had decided to take the "growth cure" out of their difficulties and unfettered access to capital and investment was the prescription. In line with this approach, the Bank Board, at the bidding of the League, lifted the 5% limit on brokered deposits.

"The feeling at the time was 'all we need is capital to reinvigorate the industry,' " Gray recalls. "As long as someone opened a thrift, he had an unlimited source of insured money to do with whatever he damn well pleased. There was no risk; all of that was being assumed by the FSLIC. Money brokers, led by Merrill Lynch, would break up deposits in $100,000 denominations and collect a handsome fee for placing them at various institutions, particularly the weak ones with the highest rates."

Meanwhile, deregulation fever raged at the state as well as the national level. California passed the Nolan Act in 1983, which for the first time ever allowed state-chartered thrifts to engage in any activity they wished. In what is probably the most liberal banking law ever passed anywhere, state-chartered thrifts in the Golden State could make unlimited equity investments in any business venture they pleased (it's a law, by the way, which, despite all the problems of the industry, still stands today). Texas, Florida and Ohio soon adopted similar legislation.

It didn't take Gray too long to realize that he had been suffering under a giant misconception. When he took the job, he naively believed that given free rein, thrift executives would behave prudently. But he soon discovered that handing many of them hot money wasn't much different from giving matches to little children. Almost in a flash, the so-called spread problem of the industry was replaced by a bad asset problem. "The notion that thrifts were free-market players was absurd," Gray observes. "These institutions didn't really have any money of their own to lose. They took in government-guaranteed funds, and if they lost, the government paid." To Gray, brokered deposits were a lethal irony, in effect creating runs of money *into* small problem institutions and in the process quickly transforming them into big problem institutions.

In attempting to clamp down on brokered deposits, Gray ran directly into a formidable obstacle—Don Regan, then the Secretary of Treasury. At their first meeting, Regan informed him that as head of the Bank Board his job was to "just do what I say." Regan refused to allow a former chairman of the Federal Home Loan Bank Board, Dick Pratt, then at Merrill Lynch, to brief the Council of Economic Advisors on the state of the thrift industry, as Gray had requested. In all the time Gray was at the Bank Board, Regan never returned one of his phone calls and ultimately tried to squeeze him out of office.

"I considered him an arrogant, conceited SOB, and nothing I ever saw persuaded me otherwise," Gray says of Regan.

Gray contends that although

Regan, as the former CEO of Merrill Lynch, had formally excused himself from the debate on brokered funds, it was precisely his long and intimate link with Merrill that caused Treasury to so doggedly oppose Gray on the issue. In what Gray described as a seven-hour telephone conversation, Deputy Treasury Secretary McNamar tried to get him to cave in. "He appealed to my patriotism, said that in interfering with the free flow of money I was being disloyal to Reagan," Gray recalls. "When I told him I was concerned because the taxpayer was going to get the bill when many of these thrifts failed, he just laughed, and called me an alarmist."

McNamar, who now operates an investment banking boutique in northern California, says he can't recall ever having a seven-hour conversation with Gray or anyone. "But we did not think it was a good idea to cut off liquidity at a time when the thrifts were in bad shape," he says.

Subsequently, when Gray thought he had secured $1 billion of brokered funds from Merrill Lynch to shore up the failing American Savings & Loan, money that would be placed in the thrift under the oversight of the Bank Board, the arrangement suddenly collapsed. "About a year later in the Fairmont Hotel in San Francisco, I found out from Dick Pratt, who was the managing director of Merrill Lynch Capital Markets at the time, that he had been overruled because Regan intervened," Gray recalls. Pratt could not be reached for comment. A spokesman for Regan said that the former Treasury Secretary had already denied these charges and would have no comment on Ed Gray.

Now Gray, remember, was a certified conservative who had been in the vanguard of the Reagan revolution. But it was with increasing distress that he saw the Administration, Congress and the states rushing to thrift regulation without the slightest thought as to the consequences to the fragile FSLIC and ultimately the taxpayer. "I fully believed that if Ronald Reagan knew what I knew," Gray asserts, "He would have done the same thing."

With limitless access to government-insured brokered deposits and carte blanche to invest this money, thrifts began to grow helter skelter. Deposits were approaching $1 trillion, FSLIC was rapidly running out of cash and the Bank Board still had fewer than 700 examiners. The Bank Board seemed doomed to remain woefully understaffed because, unlike the Federal Reserve and FDIC, it was not an autonomous agency but, instead, dependent on the Office of Management and Budget for its funding, personnel slots and authorized salary ranges.

In late August of '83, after a particularly alarming meeting with the FSLIC, Gray enlisted the aid of then FDIC Chairman William Isaac. The two agreed to work as a team to try to curb the rapid growth in brokered funds to banks and thrifts. The S&Ls didn't take kindly to the effort. Gray was accused of blocking the free flow of capital and exaggerating the problems of the industry. The Treasury Department, too, was strongly opposed to cutting off liquidity at the time because it might only serve to deepen the growing S&L crisis. Treasury believed in monitoring the individual institution instead of the industry as a whole, a strategy fatally flawed because of the lack of examiners at the Bank Board.

Gray argued, in vain, that no institution could prudently invest such large sums of money as were then flowing into the S&Ls. "In '84 banks had a 7% average growth rate of deposits," Gray notes. "The S&Ls had a 20% average. Any banker on God's green earth would agree that there's no way to make good loans that quickly."

In October of '84, however, a federal court ruled that the FHLBB and FDIC had exceeded their statutory authority in moving to curb brokered funds. Over the next several years, brokered deposits would be the primary source of funding for the bulk of the thrifts that failed in the Sun Belt.

political-action committees contributed large sums to all legislators in a position to help them, and help them the legislators did, swatting down virtually every proposal the Bank Board brought to them.

Nothing daunted, Gray took a different and bold tack: He persuaded hundreds of civil-service bank examiners to leave OMB and go to work directly for the Bank Board, thereby effectively doubling his staff between 1984 and 1986. In the fall of '86, Gray proposed a regulation limiting the growth of thrifts and another limiting direct investments in other businesses to no more than 10% of assets.

The industry, through its members and the League, reacted sharply. Treasury refused its support. The state savings commissions were incensed because Gray's proposal on direct investments would destroy the dual thrift system. At one point, Frank Annunzio, ranking member of the House Subcommittee

Unlike air ace Billy Mitchell, Ed Gray, former head of the Federal Home Loan Bank Board, has lived to see his dire predictions come true.

on Financial Institutions after St Germain and Rep. Henry Gonzalez of Texas, circulated a resolution that more than half of the House signed, to make the Bank Board rescind these regulations.

But then, in the spring of '85, Gray told the House Banking Subcommittee that if they took away the board's power, he would dump the FSLIC's problems—and losses—in the lap of Congress. That seemed to dampen congressional opposition to the new regs.

The violent opposition in the face of mounting losses made Gray aware that one of the consequences of the dual thrift system was to create a source of political contributions to state legislators and governors. If state-chartered thrifts disappeared, so too, would political contributions from the thrift industry.

No surprise, then, that Ed

Gray got little support from the Administration or Congress when he sent to the Hill legislation permitting the Bank Board to charge supplemental insurance premiums on all state-chartered thrifts that chose to venture beyond the confines of federal law. One year later he proposed a regulation requiring that the minimum net-worth level for FSLIC-insured thrifts be raised by a half-percent a year. It, too, met with strong opposition from the U.S. Savings League, which complained that Gray was devoting too much discussion to the insurance fund's problems. "Hell, why shouldn't I have been warning about FSLIC's problems?" Gray charges. "I was working for the Bank Board, not for the U.S. League."

And when Gray proposed in October of '85 that federally chartered thrifts set aside 1% of their deposits for potential use by the nearly bankrupt insurance fund, he provoked a huge outcry. Gray suggested the deposit set-aside as one of a handful of grim alternatives, and also recommended that the thrifts be allowed to collect interest on those deposits and count them as assets. No matter. The pressure became so intense that Gray actually thought of quitting and said as much to his close friend, Attorney General Ed Meese, who broached the subject to Chief of Staff Don Regan.

"Regan was receptive to Gray's going in a way that would not look like he was forced out," Meese says. "But right after our discussion, someone told The Wall Street Journal that Ed was on his way out, so, of course, then he had to stay."

It was only his conversations with Meese and monthly luncheons with Paul Volcker that kept up Gray's flagging spirits. Indeed, one of Gray's prize possessions is a 1988 letter from Volcker commending Gray for his zeal. "You did more warning and alarm sounding than any regulator in my experience," Volcker wrote Gray last October.

In March of 1986, Gray dispatched 250 examiners to Texas, where they found disasters blooming like so many crocuses. It was around this time that Gray and the Bank Board earned the nickname of "Hitler and the Gestapo" from then House Majority Leader Jim Wright for their "arbitrary marches" on Texas S&Ls. "He felt we were carpetbaggers," Gray says. "And that the only people who should have examined the situation were Texans who understood the way business was done down there."

Wright blocked passage of an emergency bill to infuse $15 billion into the deposit-insurance fund, which was clearly broke. In order to get the FSLIC recapitalization through Congress, Gray initially tried to please Jim Wright. Among the "favors" he did for Wright was replacing the conservator who had threatened foreclosure proceedings against Westwood Savings & Loan, which was owned by real-estate syndicator Craig Hall. Gray also promised Wright he would conduct an inquiry into the actions of his own investigators, who, on discovering that they could find no accurate records or books to examine, had asked both Tom Gaubert and his brother to step aside from the management of the troubled Independent

American S&L. Gray even went so far as to hire an independent investigator, Nashville lawyer Archie Harwell, from a list supplied by Gaubert's attorney. But even Harwell had to agree that the Bank Board had done nothing wrong.

Wright eventually soured on Gray when the board forced out the managers of Vernon S&L, an institution that had 96% of its loans in default. Vernon was run by Don Dixon, who was a friend of Wright's family. The closing of Vernon was delayed because the state commissioner, whose approval was needed, refused to give it because the legislature was in session. "The state regulators in Texas were in the hip pocket of their own industry and acted with impunity," Gray comments. The board's actions in Texas led Curt Prins, a staffer on the House Banking Committee, to predict that Gray would spend his retirement sleeping on heating grates with the homeless for crossing Wright.

The hemorrhaging in Texas was made worse by accounting legerdemain called acquisition, construction and development loans. A thrift would lend a developer a huge sum, requiring no money down and making the first two years of interest payments, which were usually very high, a part of the loan. "Economists call this moral hazard, because there's no risk," explains Bill Black, who was deputy director of FSLIC under Gray. "The problem, even before the fraud and criminality, was purely arithmetic. No matter how bad the loans were, a thrift couldn't lose for at least two years. In fact, many often booked record profits. This interest reserve played havoc with the regulatory process because there was no way to detract from delinquent loans."

Even when an examiner stepped in, he was often thwarted by the cunning S&Ls. Thrift operators in Texas, according to Black, would trade their dead cow for an associate's dead horse—sometimes giving an accomplice a 110% nonrecourse loan to buy a worthless piece of land. Once the swap or sale went through, the Bank Board would get a call from the indignant thrift operator under review. "I told you you were a stupid regulator that didn't understand land values," he would say, according to Black. "I just sold that 'worthless parcel' for a $5 million profit."

The S&L mess in Texas was pushing FSLIC even deeper into insolvency, so pressure was growing to recapitalize the insurance unit. But the U.S. League wanted just $5 billion in funding, not $15 billion. It was part of their policy of "buying time." In fact, U.S. League President Bill O'Connell and a number of state savings-league presidents reportedly told Gray, Black and Bob Sahadi, the former head of policy and economic research at the Bank Board, that the idea was to keep the amount down to $5 billion or less. If the funding were kept relatively low, the reasoning went, by 1989 there would be a new Administration that would find itself with a problem so bad that only a massive taxpayer bailout would solve it. Bill O'Connell did not return telephone queries.

Enter Jim Wright, who forged what Black calls a "Faustian bargain" with the U.S. League and "some of the sleaziest S&L operators in the country." The amount of the recap would be held down to $5 billion and the bill would include "forebearance provisions," which would require regulators to go easy on troubled S&Ls. After intense vote-gathering by Rep. Tony Coehlo of California, the House passed the bill and the Senate voted for a slightly stronger measure. The final bill provided $10.8 billion for the bankrupt insurance fund, $1.3 billion of which had to be pledged to Vernon alone. Wright, criticized for interfering in the regulatory process, insisted that he had only asked the Bank Board to look into the complaints of his Texas constituents. "It is the kind of thing most congressman do almost everyday for some private citizen or another," Wright explained.

The Speaker wasn't far off the mark, for in May 1987 five U.S. senators (John Glenn of Ohio, Don Reigle of Michigan, Dennis DeConcini and John McCain of Arizona and Alan Cranston of California) met with five members of the board of the San Francisco Federal Home Loan Bank to ask them not to enforce the restrictions on direct investment with regard to Lincoln Savings & Loan, another troubled institution. Charles Keating, who operated the thrift, also retained Alan Greenspan to lobby on his behalf.

By passing a weak insurance bill that required regulators to go slowly in dealing with failing thrifts, Congress had, of course, only made the problem worse. Gray would leave the board when his term expired at the end of June 1987, and, as many predicted, he encountered a good deal of trouble before landing a job as president of Chase Federal, a savings and loan in Miami. Only now, after the Bush Administration has tackled the thrift crisis head on, is Ed Gray beginning to win recognition for having fought the good fight. Congress voted Billy Mitchell a posthumous medal of honor for his efforts. At the very least, it would seem they owe Ed Gray a belated vote of thanks. ■

Senator **Graham**. In that article this situation is described relative to a former chairman of the Federal Home Loan Bank Board, Mr. Ed Gray. The article quotes Mr. Gray as making this observation:

> These institutions—that is, institutions which were in the troubled category—didn't really have any money of their own to lose. They took in Government guaranteed funds, and if they lost the Government paid.
>
> To Gray, brokered deposits were a lethal irony, in effect creating runs of money into small problem institutions and in the process quickly transforming them into big problem institutions.
>
> In attempting to clamp down on brokered deposits, Gray ran directly into a formidable obstacle, Don Regan, then the Secretary of the Treasury. At their first meeting Regan informed him that as head of the Bank Board his job was to just do what I say.

That is quite a different assessment of brokered deposits than the one that I have heard here today, particularly from Mr. White.

What has caused you to believe that Mr. Gray's characterization of "lethal irony" is no longer the case?

FHLBB HAS DIRECT REGULATORY CONTROL OVER ASSETS

Mr. **White**. Because we now have the direct regulatory control over the assets where those funds would be used. Mr. Gray back in 1984 didn't have that control and that power. We now have it, and we have better net worth regulations backing them up as well. Ed didn't have that power back then.

Mr. **Wall**. As well as growth restrictions. You can only grow to the extent to which you have got 6 percent capital for that new growth, and brokered funds are growth. There are those three categories of limitation on how fast you might accommodate brokered funds in your institution.

Mr. **White**. Senator, I served alongside Ed Gray for 7½ months, and "hot money" was one of his favorite phrases. I can understand his perspective when he came into office in 1983, seeing all this hot money, this brokered money coming into the industry and clearly being used for improper purposes, bad loans, bad investments.

He grabbed at a handle that he saw available to him, which was cut off the flow of money.

I personally believe it was the wrong handle to have grabbed. He should have gone directly to the asset side and should have tried to have cut off the bad direction in which the money was being used.

That is the direction he eventually went after the courts told him he couldn't go in the direction of cutting off the brokered money directly, and I think it is the better direction.

That is where a thrift gets into trouble, by making the bad loans.

Senator **Graham**. Since you served with Mr. Gray, do you believe that this conversation that he recounts between himself and Mr. Regan is correct and, if so, how would you—I gather from your facial expression you decline—you have no basis to assess that?

Mr. **White**. It sounds like it took place at least 2 years before I got to the Federal Home Loan Bank Board.

Senator **Graham**. Assuming its correctness, what weight would you put on it as a commentary as to whether the Home Loan Bank Board ought to be put under the Treasury? To ratify reality or . . .?

[Laughter.]

Mr. **White**. I see the direction in which you are going, Senator, and I would say that that is what comes along with the political process. It is political responsibility, and ultimately there would have been a political cost and a political price to have been paid in that kind of circumstance. I consider that entirely appropriate.

Senator **Graham**. Are there any other areas of actions or representations by the Home Loan Bank Board in the last period while you have served on the Board that have similarly been subject to political coloration?

Mr. **White**. While I was there—I am trying to think back, we all know the discussions that Ed Gray had before I got there with the Office of Management and Budget concerning the staffing of the FSLIC. The staffing of the examination force prior to midyear of 1985 was through the Washington office rather than, as subsequently turned out to be the case, through the Federal Home Loan Bank System.

But during the 7½ months that I overlapped with Ed Gray, I am not aware of any other—of any conversations. All I am aware of is the early——

Senator **Graham**. What about in the days since—in the days since Ed Gray left the Board?

Mr. **White**. No, I am not aware of any such conversations.

Senator **Graham**. Of any such?

Mr. **White**. Conversations.

Senator **Graham**. Are you aware of any attempts to provide a political coloration such as the one that was described relative to brokered deposits on any other decisions or representations or actions of the Home Loan Bank Board or FSLIC?

Mr. **White**. No, Senator, I am not aware of any.

Mr. **Wall**. Senator, might I characterize any conversations that I have had with Treasury as—being the agency in specific reference here—conversations I can recall and at times where I was asking at least for their comment. It reminded me of the days when I first served on the staff of this committee when the Fed was out there doing what they had to do to try to control inflation and everybody was only too glad they were an independent agency.

That was the view we got from the Treasury. "You got to do what you got to do" was the phrase I heard more often than anything else, and I didn't see that as a pejorative. I saw that as a piece of relief that they didn't have the responsibility that vested in the three of us.

Senator **Graham**. You referred to the situation of Beach Federal as being a particular problem of liquidity specifically in Florida, I think, Mr. Martin.

There has been some suggestions that this liquidity problem and the run that has occurred in the industry has been the market commenting on the plan for the industry's salvation. You may have seen the column in yesterday's Washington Post to that effect.

What reading should the public put on the announcement that was made here last week by Mr. Greenspan of the agreement between the Fed and the Home Loan Bank Board to provide the Fed as the depositor of last resort for the FSLIC?

Mr. **Wall**. As the lender of last resort.

The reading that one should put on that——

Senator **Graham**. The insurer of last resort.

Mr. **Wall** [continuing]. Is that just as on the day that the stock market crashed and just as in preparation for other situations we were dealing with or in preparation for other events that this committee was involved in during the years. The basic purpose is you don't have to use it. It is there. Everybody knows it is there, and they have the confidence that is the case. You never have to make a call on it, and we would clearly expect that to be the outcome here.

On the other hand, it is there. Make no mistake about it, the mechanism in place. It is ready to operate where and whenever it is needed.

I would have to say, Senator, with regard to your State, it is one where the respective markets have been about of equal size—commercial banks and the thrift institutions—over the years. Typically the thrift industry has been a little bit bigger than the commercial banking sector—very, very competitive, very, very rate sensitive.

And no question about it, it is a capital rich financial sector. So that it is a hot market, and it is a market where that kind of thing will occur one day and be gone. It will be in there for over a weekend by one institution, and the next day it is in another institution of a different kind.

So you clearly are in a very competitive market, as you well know from your previous service as Governor. I would just remind everyone here that they should not read anything into the discussion that we have had here—other than Florida has a very rate sensitive depositing public.

Senator **Graham**. Mr. Chairman, I appreciate your generosity of time. I have some other questions, but I will submit them in writing for subsequent response.

FUTURE REGULATORS SHOULD BE ABLE TO OPERATE INDEPENDENTLY

The **Chairman**. If I may follow up on one thing you have said—and it has been a theme that has come up several times today—and that is whether we call it independence or institutional independence or political independence, or whatever phrase we want to use, we nevertheless will need to have regulators in the future that really have the ability to operate independently.

We have to have, I think, a high degree of confidence that—in addition to building a solid structure, solid savings and loan structure and insurance structure for the future—the people who are responsible for administering the work each day have to be people who not only are highly competent and highly respected and able to do their job, but they have got to be able to be sufficiently insulated from interference from any direction, and that means interference from an administration, from the industry, from Congress, from anybody.

We have got to be able to have, I think, that kind of structure in place. I am not sure that we have yet been able to assure ourselves that we have hit upon precisely the design that will give us that assurance.

But I think the questions you raise, Senator Graham, are very important ones. I have heard Senator Garn raise them in a somewhat different fashion, as have I and others, but making sure that we have got not only a solid system but one that can really operate in a sufficiently independent manner I think is one of the keys to building a package here that is going to stand the test of time.

I don't know if you want to make any comment on that, Mr. Wall, but please feel free to.

Mr. WALL. I would like to make a couple of comments if I might.

I would remind you we really haven't talked much about the 12 district banks here today. The independence of the 12 Federal Home Loan Banks—and whether or not commercial banks are able to access and borrow from them and/or be members—is very important.

There has been press coverage alleging that we have more authority vis-a-vis those banks than we do and that we have demanded certain things that we have not. We are very much in a cooperative and in a discussion mode as far as the 12 district banks when we put something forward or, on the other hand, when they put something forward.

The independence of those 12 banks as a credit allocator is key—credit allocation is a very important ingredient in this whole piece. Those banks have been created and are a very important part of the industry with $165 to $170 billion in assets. Last year they paid dividends of $1,230,000,000 to the stockholder S&L and savings bank institutions—an incredible amount of the profits, if you look at it in the simplest sense, of the industry.

So those banks and their being able to survive as viable and independent entities are very important.

Mr. WHITE. I would also add——

The CHAIRMAN. Well, please finish, Mr. White, and then I want to give Jake a chance.

Mr. WALL. At this point—or in markup—we also will have some technical amendments and language that will be working with your staffs on. A task such as this—to put together a piece of legislation in the time that was available to the Treasury and to our lawyers and FDIC and others—was incredible. And I think they did a wonderful job. But clearly there are going to be a lot of things that have to be pointed out just in the nature of making it work.

Mr. WHITE. And let me add to what Chairman Wall just said. The way the Congress set up the Federal Home Loan Bank System 57 years ago, the savings and loans that are members of their regional Federal Home Loan Banks are also stockholders in those banks. They also have their own capital at risk in those banks.

The net worth of those Federal Home Loan Banks are an asset of their constituent savings and loan stockholders, and so it is really their stockholders' money that is at risk in the activities of those Federal Home Loan Banks. The boards of directors of those Federal Home Loan Banks are very aware of that.

They have fiduciary obligations with respect to protecting the investments of their constituent members. That has to be taken into account in any of the discussions, certainly in the working out of the President's proposal.

Any efforts to take assets, to take net worth, from the Federal Home Loan Banks is a direct reduction in the effective net worth of the constituent savings and loan industry itself.

The CHAIRMAN. Senator Garn, any final comment from you?

Senator GARN. Just a brief final comment. I will submit the remainder of my questions for response in writing, but I would like to thank not only these three witnesses today but all of the witnesses we have had.

I have sat on this committee—and this is my 15th year now—and often listened to a lot of evasive testimony. I think through this whole series of hearings we may not have liked all of the answers, but I appreciate the direct responses we have had from all of the witnesses.

And I also want to complement the members of the Banking Committee, although I wish we did not have such a large committee. When I was chairman, I fought to get it cut down to 15, and we have grown again until we hardly have chairs for everyone. Nevertheless, I have been particularly impressed with the new members and the quality of their participation and their questions.

I listened to Senator Bryan today, who has been in the Senate for a couple of months, and others, and they have been asking good questions and obviously doing their homework.

I also spent a lot of time sitting in that chair alone, with no one here, conducting hearings; and I have been impressed, with all of the other things going on, that we have had such good participation from members of the committee. I think that the unusually high participation of members, even with conflicting schedules, the quality of the questions, and the homework that members of the committee are doing highlight the importance of this issue and the speed with which we should act.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

The committee stands in recess.

[Whereupon, at 12:44 p.m., the committee was adjourned.]

PROBLEMS OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC]

PART II OF IV

THURSDAY, MARCH 2, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Dixon, Shelby, Wirth, Bryan, Garn, Heinz, D'Amato, Gramm, Bond, Mack, Roth, Kassebaum, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me welcome all that are present and we are pleased to have the Director of the Office of Management and Budget, Mr. Richard Darman, with us this morning.

As is the case this week and at this time of the year, we have a number of hearings going on simultaneously in other committees. For example, Bill Seidman is testifying on the FSLIC issue upstairs now in the Budget Committee. Those of us who also serve as members of the Budget Committee find ourselves having to try to be in at least two places at once. So, we will have members coming and going in the course of the morning, and as is our practice, we will work members into the discussion as they are able to be here.

This is our first occasion to have Mr. Darman before our committee, and we are delighted to welcome him. He's put in many years of service in the Federal Government, now in a new capacity, and we look forward to developing and maintaining a very fine working relationship as we get down the track.

With respect to the issues that are before us today, we've been exploring the regulatory features of the administration's proposal at some length since we have gotten them in writing. We have gone over them with other witnesses in the past weeks.

Now is the time and today is the beginning of the process of getting very deeply into the funding side of the package. I tend to view the package in two broad categorical sections; one the reform and structural issues; and the other the question of how do we finance the solution.

Some aspects of the financing arrangement are extremely complicated, but it's important that we work through the complexities and understand precisely how the plan would work and what the ultimate cost would be.

The FDIC has done an elaborate diagram of the funding mechanism that points out how extraordinarily complicated it is. There's a real question as to whether it needs to be that complicated, and whether, in fact, there are benefits that are gained by the complexity.

I think it's fair to say that in a package of this size even small improvements that we might be able to make could amount to billions of dollars of savings to American taxpayers. So, we want to be sure as we go through the funding mechanism that we miss no chance to get the cost down to the lowest possible level.

There are really two main areas of concern on the funding side. Is there enough funding, and is it provided in the cheapest way possible?

I think there are reasons to have uncertainty on both grounds. We want to be sure there's enough money to have a prudent expectation of being able to get the job done without the need for further legislation either several months or a year or two in the future. The cost of FSLIC's resolutions last year were virtually open-ended. The cost of future resolutions will vary greatly depending upon interest rate levels. In fact, interest rate increases of more than 3 percentage points over just the last year alone probably means that losses at insolvent institutions have been piling up very rapidly.

These losses will continue until all failed thrifts are sold or liquidated. If interest rates should continue to rise, the losses will go even higher.

We don't want the FDIC to delay resolutions or use costly guarantees because they are faced with a situation of not having enough cash to work with. If liquidations are cheaper than mergers, we may need more money early on to close insolvent thrifts and to warehouse the assets. If we can save money by refinancing some of last year's deals that were done in the press of the year-end deadline change in the tax laws, if we can reduce some of those costs by paying off FSLIC notes associated with those deals or buying out of the yield maintenance agreements, we may want to do that as well.

That would also require a larger funding package initially even though the ultimate cost would be lower. So we need to consider factors of that kind.

We also need to consider whether the funding should be on budget or off budget. There clearly is a difference as well with respect to the question of whether or not we finance directly through the Treasury or through an indirect financing mechanism which has with it some premium financing costs.

There is no one better suited to discuss this with the committee than Director Darman. We will be very interested in his comments today, and we have a number of detailed questions, some of which we'll go through today and some of which we will want to work with you and your people with in the days ahead.

With that, let me yield to Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator **Garn**. Thank you, Mr. Chairman.

I'm happy to welcome you here. I can't remember when OMB appeared before this committee the last time. I don't know whether that's good or bad, but that you are here to testify on the numbers certainly indicates the importance of this issue, and today the focus is obviously on the numbers involved with the administration's plan.

We have already heard some testimony about them from the Treasury Department and others. To be honest, Dick, there's still some confusion about exactly what the numbers mean and about the assumptions that have been used. I hope you're able to clear up some of that confusion today.

I do have a few observations. First, my understanding is that the plan calls for a total of $83 billion in connection with the new case resolution and the buildup of the new SAIF fund over the next 10 years. That's $50 billion for insolvencies we know about, $24 billion for new insolvencies that are expected to occur, and $9 billion to build SAIF. I've already been told that Treasury essentially guarantees that these maximum amounts will be available even if receipts from the industry are somewhat different than you expect.

I would like to know whether my understanding is basically accurate on that issue.

Second, it seems to me that all the talk about the plan's enormous interest costs over 30 years is really misleading. We all know we have to finance the cost of any plan over a long period of time and if you add up all the interest costs it would be a giant number, no matter how you do it. It's no different than a mortgage on a house. The purchase price may be $100,000. The total interest costs over a 30-year mortgage may be another $300,000. That doesn't mean we say the price of the house is really $400,000.

My point is that these large financing costs occur whether we have a plan that's on-budget or off-budget. In both cases the financing costs will go up if interest rates rise and down if they drop.

The key issue that we need to explore is the difference in financing costs between the two alternatives. It really is significant both on a yearly basis and over time. What are the reasons for choosing one over the other? I hope you are able to address that difference for us today.

Thank you, Mr. Chairman.

The **Chairman**. Thank you very much, Senator Garn.

Senator Shelby.

OPENING STATEMENT OF SENATOR SHELBY

Senator **Shelby**. Thank you, Mr. Chairman.

Mr. Chairman, I want to join you and Senator Garn and my other colleagues in welcoming today's witness.

Mr. Darman, we appreciate your appearing today to discuss the specifics of the Bush proposal. Your job, that of putting together the numbers for this proposal, is certainly among the most difficult.

Other witnesses have stated, and from your testimony you appear to concur, that attempting to get an exact figure is an academic exercise here. Members were told yesterday that the only thing that we can be certain of with any figure is that it's wrong, that there are just too many variables out there to calculate accurately.

I understand that basic assessment. However, I believe that we—both Congress and your administration—have an obligation to come up with a proposal that is as close to the bull's eye as is possible. At this time the public perception is that Government was asleep at the wheel. We've discussed at length in this committee who is at fault in this crisis and we've found that there is more than enough blame to go around.

If we have to revisit this a few years down the road, that will no longer be the case. We hopefully will not have a depressed regional economy or national economy. We'd better not have a fraudulent management and we'd better not have a lax regulatory system here. If we have to revisit this in any significant fashion a few years down the line, there will only be two groups to blame—Congress and this administration.

Thus, the numbers that we choose now, while perhaps inaccurate, will be very significant. If we lowball the figures, make unrealistic economic assumptions, engage in budgetary gimmickry to the extent that we substantially underestimate the cost of the resolution, we will be violating the taxpayers' trust and do extensive damage to the perception of the Federal Government.

I do not want to revisit this issue. The resolution of the crisis has been avoided long enough at significant cost. At this time the public attention focused on this issue gives us a mandate to act. Thus, it is imperative that we do something that works and that we do it efficiently and expeditiously.

I appreciate, Mr. Darman, the difficulties of your task. However, I want to stress it would be a disservice to this administration and the taxpayer if OMB and the Treasury substantially underestimate the problem in order to create an illusory consequences in the next few years' budget.

I anticipate that the present figures may undergo some revision between now and then and that a proposal is adopted. I hope that the revised figures will seek to hone in on the target.

I look forward to the question and answer period.

The CHAIRMAN. Thank you, Senator Shelby.

Senator D'Amato.

Senator D'AMATO. Mr. Chairman, I am going to ask that my statement be included in the record as if read in its entirety.

The CHAIRMAN. Without objection.

Senator D'AMATO. I welcome Mr. Darman. I want to say that I think that the Bush administration should be commended for undertaking to address this problem. It recognizes and Mr. Darman recognizes and Chairman Greenspan yesterday recognized the absolute certainty of the fact that there is no figure that is accurate. I commend Senator Shelby for his enlightened approach in his statement to this effect, and I say that we indeed are fortunate to have an OMB Director who is as bright, who's got perspicacity, and has always been up front. Sometimes we don't like the truth, but that's been Dick Darman's reputation and we certainly look forward to working with him. I know he's going to do the best he can in a situation that will continue to change courses as we move along.

So, Mr. Chairman, I am delighted to see Dick Darman here with us today.

[The complete prepared statement of Senator D'Amato follows:]

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I would like to welcome Budget Director Darman and his able staff to the Banking Committee. I will take another opportunity to commend the Bush administration team for its comprehensive and positive approach to this problem. The OMB role in this plan is central because the budget deficit is seldom far from our minds when we work on many of the important matters before the Congress and especially when we work to eliminate the FSLIC dificit.

The budget implications of this plan are important and up-front on-budget scoring of the actual Treasury funds used is imperative. As I understand the Bush proposal, it will accomplish that.

I agree with Chairman Greenspan that we should not insist on absolute certainty as to the cost of this recapitalization. The best minds in the country disagree widely as to the ultimate cost. Indeed, to attempt to predict, with certainty, the economic future when we cannot agree even as to why things happened in the economic past would be a time-consuming and counterproductive effort. Therefore, I agree with Chairman Greenspan that our task is to launch a conceptually sound program and recognize that a "mid-course correction" may be necessary. Action is what is required and I look forward to hearing the OMB perspective.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator D'Amato.

Senator Bryan.

Senator BRYAN. Thank you, Mr. Chairman.

I, too, welcome Mr. Darman to the committee this morning and look forward to hearing from him and I will yield my time back.

The CHAIRMAN. Thank you.

Senator Bond.

Senator BOND. Mr. Chairman, I just want to take this opportunity one more time on the record to thank you for the very professional and very fair way that you have approached this. We appreciate very much the briefings that you have provided for us and your dedication to getting this committee to work together on a very difficult problem. I am grateful for it and I think that the work of the committee will reflect the very fine leadership that you are providing.

I, too, want to commend my colleague, the Senator from Alabama, for his very thoughtful comments as well as the thoughtful comments of our ranking member, Senator Garn. I would say that we not only welcome Mr. Darman, we congratulate him on the brevity of his statement and following on that fine example I shall make no further.

The CHAIRMAN. Thank you, Senator Bond. Thank you for the very kind personal comments.

Senator Wirth.

Senator WIRTH. Thank you, Mr. Chairman. I have no comment other than to welcome Mr. Darman.

The CHAIRMAN. Very good.

Senator Mack.

Senator MACK. I just welcome Mr. Darman and look forward to the testimony and its impact on the budget outlays as we look forward to 1990–91 and so forth. Thank you, Mr. Chairman.

The CHAIRMAN. Very good.

Senator Heinz.

Senator HEINZ. Mr. Chairman, just two brief comments, in addition to welcoming Mr. Darman here. First, I suspect that you're going to hear to some extent justified comments that because this plan is off-budget the cost is being raised. That may very well be true based on the numbers many of us have looked at. Kit Bond has already thanked Senator Riegle for the excellent briefings we have had. We have been well briefed by a number of sources, including some people working pro bono who have gone over this plan. I must tell you this is an issue we will want to explore with you today. But even so, when it comes to saving the taxpayers' money, it seems to me the best thing we could do after we get the answers is to move ahead quickly because one thing is certain: the longer we delay the higher the cost to the taxpayers.

With respect to substance, I'm going to keep both my mind and my pocket calculator open because I must tell you I am skeptical of the 30-year funding plan summary that you provided us which shows that the taxpayers are going to earn $8.1 billion from this program. I hope you're not using your own version of RAP accounting. I intend to ask you a few questions about that.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Gramm.

Senator GRAMM. Mr. Chairman, I welcome Mr. Darman before the committee. I feel on this savings and loan problem the way I always feel about the budget. Every year on the budget we spend tremendous amounts of time debating what the reality is and very little time doing anything about it. To tell you the plain truth, I don't know how deep the hole is out there in the savings and loan industry, and my guess is nobody knows, but the longer we wait in starting to fill it up, I'm certain the deeper it will be.

So my view is we ought to come up with a credible program. I congratulate the Treasury Department for the program they have come up with. I think we ought to make the changes that we think are necessary to improve it, but I think we ought to get on with it and try to make it work and try to make the cost as low as possible. That's what I am committed to, and I thank the chairman for his leadership in this area. If every committee of Congress worked as hard or as expeditiously as this one, we would soon solve the nation's problems.

The CHAIRMAN. I thank the Senator. I might just say before calling on our witness that yesterday we received some additional data and I wanted to mention this with you present. We received when you could not be in the room, but in looking at the loss resolution figures for 1988, fully 50 percent of those losses were in the State of Texas and I think it helps bear out some of the things that the Senator said before about the regional nature of the problem.

Before we begin, I have statements from Senators Dixon and Sasser for insertion in the record.

[The statements of Senators Dixon and Sasser follow:]

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee continues its hearings on the thrift industry crisis. I look forward to hearing the views of the Director of the Office of Management and Budget, Richard Darman.

I appreciated the candor and simplicity of Mr. Darman's views when he described his "duck" test for determining what is a tax, during his confirmation hearings with the Senate. We need that same sort of candor and simplicity for determining the best way to finance the resolution of the savings and loan crisis.

I believe that the solution should be on-budget. I think we undermine our own credibility and the budget process to even consider spending $90 billion or more over the next 3 years without including those sums in the budget. If the budget process is to work, if we are ever to eliminate the persistent budget deficits, we need to be honest.

This is too much money to try to hide. We should be honest with the American people. We should call a duck, "a duck"; a tax, "a tax"; taxpayer dollars, "taxpayer dollars"; and, a Government guarantee, "a Government guarantee".

If we borrow money to finance a solution, as we must, let the Government guarantee be a direct Government guarantee. That will mean that fewer taxpayer dollars will be needed to pay interest costs. Requiring fewer taxpayer dollars, in my view, will be a better solution.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Mr. Chairman today we welcome before the committee, the Director of the Office of Management and Budget, Richard Darman.

The impact on our Nation's budget of President Bush's plan to rescue the insolvent thrifts is a critical issue. While the President's plan calls for a combination of "on" and "off" budget financing, the Treasury still winds up picking up a good part of the tab.

The plan calls for $40 billion to resolve thrift institutions that have already failed and $50 billion more to bail out institutions that are insolvent but still in operation. However, more and more studies indicate that these costs will be substantially higher. I am very concerned about the potential impact of higher costs on our budget deficit.

The interest rates that are assumed under the President's plan are particularly troublesome to me. Indeed, I have often accused this administration of formulating economic assumptions through rose-colored glasses. Mr. Chairman, it is painfully obvious that this is happening today in light of the current tightening of our money supply by the Federal Reserve. I'm just not convinced that it is safe to assume that the interest rates of the FSLIC bonds used to pay for much of the bailout will be down to 7.8 percent in 1990 or 6.1 percent in 1991, much less at 4.0 percent by 1994.

A realistic estimate of the cost of the FSLIC insolvencies and a capable financing mechanism must be developed now. The savings and loan industry, and our economy in general, cannot afford to revisit this situation again.

Thank you, Mr. Chairman.

The CHAIRMAN. With that, Mr. Darman, we would be very pleased to hear your statement at this time.

STATEMENT OF RICHARD G. DARMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. DARMAN. Thank you very much, Mr. Chairman. It's a brief statement, so with your permission I will actually read it.

Chairman Riegle, Senator Garn, and distinguished members of the Senate Committee on Banking, Housing, and Urban Affairs, I thank you. Thank you for your kind introductory comments. It is a pleasure to appear before you today to discuss the administration's comprehensive reform proposals: the Financial Institutions Reform, Recovery, and Enforcement Act.

I am aware that you have already received testimony from several administration witnesses: Secretary Brady, Chairmen Seidman, Wall, and Greenspan; Comptroller Clarke; and Attorney General Thornburgh—as well as from respected outside experts. You do not need me to go over ground that is by now familiar. So in the interest of making the best use of your time, I propose to be extremely brief in my introductory remarks.

Please let me make just these five summary points:

(1) "The problem" (or the cost of resolving the problem) is, by any reasonable measure, extremely large. Various respectable estimates now range from about $80 to about $110 billion (excluding financing costs). Comparison of these estimates is not entirely straightforward. Methodologies vary. Definitions vary. But the pattern is generally consistent with the administration's estimate.

(2) Estimated Federal outlays associated with the administration's approach to resolving the problem total almost $40 billion over 10 years. "Outlays" represent a relatively clear concept (unlike such arguable concepts as "cost to the taxpayer"). Nonetheless, the outlay figure is, of course, an estimate—subject, as always, to error.

(3) The pattern of outlays and other flows associated with the administration's approach to resolving the problem is complex. A relatively complete picture is presented, however, as an appendix to this testimony, and I ask, Mr. Chairman, that the appendices be included in the record.

The CHAIRMAN. Without objection.

Mr. DARMAN. Thank you.

(4) Implementation of the administration's plan would require the authorization of fiscal year 1989 and fiscal year 1990 appropriations, and those are the only ones I mention, for four purposes:

—To cover certain FSLIC losses: $1.3 billion in fiscal year 1990;

—To cover liquidation of FSLIC debt: $0.3 billion in fiscal year 1990;

—To cover Treasury payments of REFCORP interest: $0.5 billion in fiscal year 1989; $1.4 billion in fiscal year 1990;

—To cover expansion of Justice's antifraud program ("FIST"): $37 million in fiscal year 1989; $50 million in fiscal year 1990.

The plan would also require an increase in FDIC's existing borrowing authority from Treasury—moving it from $3 billion to $5 billion; and it would require a separate $5 billion in borrowing authority—from Treasury—for the new Resolution Trust Corporation.

(5) It is, of course, the case that estimates of various flows are sensitive to several variables—and that interest rates are especially important in this context. From this particular perspective, the effect of rising interest rates is generally adverse. However, the recent rise in rates does not lead me to conclude that we should modify our approach to the S&L problem. Rather, it leads me to urge more strongly that the Congress should act promptly on both our proposals for the S&L sector and our proposals for deficit reduction generally.

I should be happy to elaborate upon these or any other points in response to your questions. Mr. Chairman and members of the committee, again, I thank you for inviting me here today.

One final comment, Mr. Chairman. A number of questions were raised by Senators in their introductory comments and I would follow your direction on how I should treat those questions. I have made note of them and I would be happy either to answer them now or to do so later.

[The appendices of Richard Darman follow:]

Attachment A

PROPOSED "FIRRE" ACT: FLOWS ASSOCIATED WITH FINANCIAL SECTOR REFORM

(In billions of dollars)

	1989	1990	1991	1992	1993	1989–1999
FSLIC and RTC Account						
Disbursements:						
Old cases and other expenses:						
Administrative and miscellaneous	0.3	0.3	0.3	0.3	0.3	2.8
Notes issued	9.7	—	—	—	—	9.7
Interest on notes outstanding	1.4	1.5	1.1	0.9	0.8	9.2
Repayment of notes issued prior to 1987	—	—	0.2	—	0.2	0.5
Assistance payments	5.2	4.4	3.8	4.2	3.4	28.8
Liquidations	1.0	—	—	—	—	1.0
Total, old cases and other expenses	17.7	6.2	5.5	5.4	4.7	52.2
New cases:						
Assisted mergers	5.0	12.5	8.5	1.2	1.8	44.0
Liquidations	5.0	12.5	8.5	1.2	1.8	30.0
Total, new cases	10.0	25.0	17.0	2.4	3.6	74.0
Total disbursements	27.7	31.2	22.5	7.8	8.3	126.2
Collections (–):						
FICO proceeds (CEBA) (–)	–3.8	–3.3	—	—	—	–7.1
New REFCORP proceeds (–)	–10.0	–25.0	–15.0	—	—	–50.0
Insurance premiums:						
Before deductions (–)	–2.1	–2.3	–2.7	–2.9	–3.1	–31.6
Deduct (+):						
FICO (CEBA) interest	0.6	0.9	1.0	1.0	1.0	10.7
Secondary reserve credit	0.1	0.1	0.1	0.1	0.3	0.7
Defease new bond principal	—	1.7	1.7	—	—	3.3
Net premium income (–)	–1.4	0.4	0.1	–1.8	–1.7	–16.9
Proceeds from receivers and corporate-held assets (old cases) (–)	–1.4	–1.4	–1.2	–1.0	–1.4	–9.7
Income on investment balances (–)	–0.1	—	—	—	–0.1	–1.1
Other collections (–)	–0.4	–0.4	–0.4	–0.3	–0.3	–3.5
Total collections	–17.0	–29.8	–16.5	–3.2	–3.6	–88.3
FSLIC/RTC net outlays	10.7	1.4	6.0	4.6	4.7	37.9
Repayments of notes issued after 1986	0.4	0.3	0.1	—	1.1	19.2
Balance of FSLIC notes outstanding (end-of-year)	19.2	18.9	18.6	18.5	17.3	—
FSLIC/RTC cash/investment end-of-year balances (9/30/88 = $1.9 billion):						
Balance for cases	0.6	0.5	0.5	0.5	0.5	0.5
Balance for new fund	—	—	—	1.0	2.1	8.8
Summary of Accounts Affected						
FSLIC net outlays	10.7	1.4	6.0	4.6	4.7	37.9
Treasury contribution to REFCORP interest	0.5	1.4	1.6	0.9	0.8	22.0
Additional FDIC collections	—	–0.8	–1.6	–1.7	–1.8	–19.9
Total budget outlays	11.1	1.9	6.0	3.8	3.7	39.9

Attachment B

PROPOSED "FIRRE" ACT: FUNDING SUMMARY

(In billions of dollars)

	1989	1990	1991	1992	1993	1994	1989–1994	1989–1999
FSLIC/RTC Disbursements	27.7	31.2	22.5	7.8	8.3	5.8	103.2	126.2
Old Cases and Other Expenses	17.7	6.2	5.5	5.4	4.7	3.8	43.2	52.2
New Cases	10.0	25.0	17.0	2.4	3.6	2.0	60.0	74.0
Collections (–)	–17.0	–29.8	–16.5	–3.2	–3.6	–3.5	–73.5	–88.3
New FICO (REFCORP) Bonds	–10.0	–25.0	–15.0	—	—	—	–50.0	–50.0
Old Premiums (Net)	–1.4	0.4	0.3	–1.5	–1.5	–2.0	–5.6	–19.0
Additional Premiums[1]	—	—	–0.3	–0.3	–0.3	0.4	–0.4	2.1
Other Old Collections	–5.6	–5.2	–1.6	–1.4	–1.8	–1.9	–17.5	–21.4
FSLIC/RTC Net Outlays	10.7	1.4	6.0	4.6	4.7	2.3	29.7	37.9
Treasury Payments for Bond (REFCORP) Interest	0.5	1.4	1.6	0.9	0.8	1.1	6.3	22.0
Additional FDIC Collections	0.0	–0.8	–1.6	–1.7	–1.8	–1.9	–7.9	–19.9
TOTAL BUDGET OUTLAYS	11.1	1.9	6.0	3.8	3.7	1.5	28.1	39.9

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[1] A (–) indicates increase in premiums, a (+) indicates a decrease.

Attachment C

PROPOSED "FIRRE" ACT: REFCORP FINANCING

(In billions of dollars)

	1989	1990	1991	1992	1993	1994	1989–1994	1989–1999
NEW FICO (REFCORP) [1]								
PRINCIPAL covered by zeros paid with private funds:								
FHLB Retained Earnings	0.8	1.1	0.8	0.0	0.0	0.0	2.7	2.7
S&L Insurance Premiums	0.0	1.7	1.7	0.0	0.0	0.0	3.3	3.3
TOTAL DEFEASANCE	0.8	2.8	2.5	0.0	0.0	0.0	6.0	6.0
INTEREST covered by private and public funds:								
FHLB future income	0.0	0.0	0.0	0.3	0.3	0.3	0.9	2.4
Receivership Proceeds	0.0	0.5	1.8	2.6	2.7	2.4	10.0	12.0
Treasury funds	0.5	1.4	1.6	0.9	0.8	1.1	6.3	22.0
TOTAL INTEREST	0.5	1.9	3.4	3.8	3.8	3.8	17.2	36.4

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[1] Sells long-term bonds: $10 billion in FY 89, $25 billion in FY 90, $15 billion in FY 91.

Attachment D

PROPOSED "FIRRE" ACT: CASH FLOW FOR GOVERNMENT

(In billions of dollars)

	1989	1990	1991	1992	1993	1994	1989–1994	1989–1999
Cash Inflows (–):								
FSLIC/RTC collections from FICO	–3.8	–3.3					–7.1	–7.1
FSLIC/RTC collections from REFCORP	–10.0	–25.0	–15.0				–50.0	–50.0
S&L Premiums and other FSLIC Collections	–3.3	–1.5	–1.5	–3.2	–3.6	–3.5	–16.4	–31.2
Additional Collections to FDIC	0.0	–0.8	–1.6	–1.7	–1.8	–1.9	–7.9	–19.9
TOTAL CASH INFLOWS	–17.0	–30.6	–18.1	–4.9	–5.4	–5.5	–81.4	–108.2
Cash Outflows:								
Old Cases and administrative expenses—cash	8.3	6.5	5.6	5.4	5.7	3.8	35.3	61.6
RTC cases	10.0	25.0	15.0				50.0	50.0
Post-RTC Cases			2.0	2.4	3.6	2.0	10.0	24.0
Contribution to REFCORP interest costs	0.5	1.4	1.6	0.9	0.8	1.1	6.3	22.0
TOTAL CASH OUTFLOWS	18.8	32.9	24.2	8.7	10.1	7.0	101.7	157.6
Net cash outflows	1.8	2.3	6.1	3.9	4.8	1.5	20.2	49.3
Debt transaction adjustments:								
New FSLIC debt issued	9.7	0.0	0.0	0.0	0.0	0.0	9.7	9.7
Redemption of FSLIC debt	–0.4	–0.3	–0.1	0.0	–1.1	0.0	–1.9	–19.2
NET COST TO GOVERNMENT (Budget Outlays)	11.1	1.9	6.0	3.8	3.7	1.5	28.1	39.9

Attachment E

PROPOSED "FIRRE" ACT: SELECTED ASSUMPTIONS

(Dollar amounts in trillions)

Assumptions	1989	1990	1991	1992	1993	1994
FICO (CEBA) Rates (wtd. avg. 1988–90: 9.5%)	9.8%	8.6%				
REFCORP Rates (wtd. avg. 1989–91: 7.7%)	9.1%	7.9%	6.5%			
Interest Rate on LT Treasuries (wtd. avg. 1989–91: 7.4%)	8.8%	7.6%	6.2%			
Discount on zeros (wtd. avg. 1989–91: 7.4%)	8.3%	7.6%	6.2%			
Interest Rate on FSLIC Notes	9.5%	7.8%	6.1%	4.9%	4.3%	4.0%
FSLIC Deposit Base (1989–99 Growth Rate: 7.2%)	1.0	1.1	1.2	1.2	1.3	1.4
FDIC Deposit Base (1989–99 Growth Rate: 6.9%)	2.1	2.3	2.4	2.6	2.8	2.9

Recovery on receivership assets (new cases): 40 cents on each dollar over the 4 years subsequent to liquidation.

Attachment F

PROPOSED "FIRRE" ACT: COST OF REFCORP BONDS THROUGH MATURITY (FY 2021)

(In billions of dollars)

	Simple Summation			Present Value in FY 89 $ at 9.00%
	1989–94	1989–99	1989–2021	
REFCORP Bond Interest Costs Paid By:				
FHLB Earnings	0.9	2.4	9.0	2.6
Receivership Proceeds	10.0	12.0	12.0	8.6
Treasury funds[2]	6.3	22.0	[1] 94.1	[1] 26.6
Total	17.2	36.4	115.1	37.8
Interest Premium over Treasury [3]	0.6	1.2	3.8	1.2

[1] Reflects interest payments over 33 years (1989–2021).

[2] These estimates assume no returns from warrants or other equity interests held by the RTC.

[3] Assumes 25 basis point spread over comparable Treasury financing.

Attachment G

PROPOSED "FIRRE" ACT: 30-YEAR FUNDING SUMMARY: 1989–2018

(In billions of dollars)

	Simple Summation			Present Value in FY 89 $ at 9.00%
	1989–94	1989–99	1989–2018	
FSLIC/RTC Disbursements	103.2	126.2	175.4	111.7
FSLIC/RTC Collections	–73.5	–88.3	–174.2	–88.0
FSLIC/RTC Net Outlays	29.7	37.9	1.1	23.6
Treasury Payment on New Bond (REFCORP) Interest	6.3	22.0	[1] 89.2	[1] 26.3
Additional FDIC Collections	–7.9	–19.9	–98.5	–26.2
Total Budget Outlays	28.1	39.9	-8.1	23.8

[1] Reflects interest payments over 30 years (1989–2018).

ATTACHMENT H

CONGRESSIONAL RECORD — SENATE

CREDIT UNION PROVISIONS OF LEADERSHIP AMENDMENT NO. 3027, AS AMENDED, TO OMNIBUS DEFICIT REDUCTION ACT OF 1984

(Through inadvertence the following statements were omitted from the RECORD of yesterday. The statements will be printed in the permanent RECORD of May 17, 1984, prior to the vote on amendment No. 3027, as amended.)

IN SUPPORT OF CREDIT UNION PROVISIONS OF LEADERSHIP AMENDMENT

Mr. GARN. Mr. President, as chairman of the Banking Committee, I rise today in support of the amendment offered by the leadership, which contains language identical to S. 2522, a bill which deals with credit unions, their central liquidity facility, and the insurance of their members' share accounts. The bill was polled unanimously out of the Banking Committee and reported to the full Senate on April 2, 1984. It is a combination of two bills which Senator PROXMIRE and I introduced on November 17, 1983, numbered S. 2120 and S. 2121; and of S. 2122, which I also introduced on that date.

The bill as reported provides for a large increase in the funding of the national credit union share insurance fund, (NCUSIF) with a corresponding decrease in the Federal deficit, exempts the NCUA's central liquidity fund from Federal, State and local taxation, and eliminates the fee imposed by the Treasury Department on financial institutions which receive payroll deductions from Federal employees. The measures have been revised to a minor extent since they were introduced.

These proposals were the subject of Banking Committee testimony by the Credit Union National Association (CUNA) and the National Association of Federal Credit Unions (NAFCU) on February 28, 1984, and by Chairman Callahan of the NCUA during the Banking Committee's banking deregulation hearing on March 21, 1984. The bill as reported has the support of the above organizations and the Treasury Department, all of which have been very helpful in moving the legislation forward. I understand that Chairman ST GERMAIN and ranking member WYLIE of the House Banking Committee are supportive of the measures contained in the bill. Moreover, Congresswoman MARY ROSE OAKAR introduced H.R. 3874, which exactly parallels the fee allotment language in S. 2522, and was instrumental in the House's passage of H.R. 3874. H.R. 3874 has been sent to the Senate and remains on the Senate Calendar.

I must also express my thanks to Chairman DOLE of the Finance Committee for his favorable consideration of my recommendation that a Finance Committee proposal to tax credit unions, estimated to gain $300 million in revenues over the next 3 years, not be pursued in light of the $1 billion contribution to the Federal Treasury that credit unions will make in a shorter period and in no event in more than 3 years, under the provisions of the NCUSIF recapitalization plan in this bill.

The following is a description of the three components of the bill:

1. TAX EXEMPT STATUS FOR THE CLF

Established in 1978 by Public Law 95-630, the Financial Institutions Regulation and Interest Rate Congrol Act, the CLF is the "central bank" for credit unions. The CLF is a mixed ownership corporation (stock owned by credit unions), is on-budget and is located within and managed by the NCUA. The bill would correct an oversight in the enactment of P.L. 95-630 which provided that the CLF be similar to Federal Reserve Banks and Federal Home Loan Banks but did not explicitly exempt the CLF from taxation.

For the past few years, the CLF pursued a tax exemption directly from the IRS and in October of last year received a ruling denying the request and stating that specific legislation was necessary to correct the situation. During the past four years, the CLF has made payments of $1.3 million to the IRS, with the bulk of the taxes, $1.1 million, incurred in 1983. In addition to the inequity of taxing one federal liquidity facility and not taxing other similar governmental entities, the result is that reserves and individual earnings of the CLF suffer.

This past month, twenty-nine corporate central credit unions joined the CLF, contributing capital of over $200 million to the CLF. With this addition, more than 18,000 credit unions (approximately 90 percent of all credit unions) will have access to CLF financing. With enactment of the bill as reported, credit unions and their members can be assured that the CLF will continue to be able to increase its capital and reserve accounts.

2. RECAPITALIZATION OF NCUSIF

The bill would increase the capitalization of NCUSIF by authorizing NCUA to impose a capital assessment on insured credit unions equal to 1 percent of their insured share accounts. The NCUSIF currently has approximately $250 million in capital, equal to 0.3 percent of insured shares, whereas its statutory normal operating capital level is set at 1 percent. The FDIC and FSLIC funds are both funded at about 1.3 percent of insured deposits.

CBO estimates that the NCUSIF proposal, in fiscal year 1985, would increase its capital to $1.25 billion through credit union capital transfers of $1 billion. (This assumes a growth rate in insured shares of 10 percent per year over the next 18 months). This would bring NCUSIF up to an appropriate capital level which is comparable to that of the FDIC and FSLIC.

Under the present system, NCUA increases NCUSIF's capital through undivided earnings and reserve accounts. Revenue to accomplish this, as well as to operate the fund, flows from annual premiums charged to credit unions. Because of the rapid growth in credit union insured deposits in the past two years (19 percent in 1982 and 18 percent in 1983), NCUA has charged a double insurance premium, equal to 1/6 of 1 percent of a credit union's insured shares; but since this has not increased NCUSIF capital enough (NCUSIF's equity/insured shares ratio has been between .25 percent and .32 percent for the past 5 years), NCUA developed the recapitalization plan to assure itself and credit unions of the stability and soundness of NCUSIF.

Under the 1 percent capital contribution program, credit unions would be required to deposit 1 percent of their insured shares and maintain that percentage permanently. With its existing equity, NCUSIF's capital would total 1.3 percent. If the total insured shares dropped, NCUA would decrease the deposit and, if NCUSIF's equity exceeds the 1.3 percent level in any year, distribute the excess to credit unions. The capital contribution would be refundable to credit unions upon leaving NCUSIF. NCUA would have the authority to phase-in the 1 percent transfer and it is expected that it will consider such a course in order to accomodate the specific financial needs of many credit unions.

While the recapitalization plan would require credit unions to sell liquid asset, the overwhelming majority support this proposal. Both CUNA and NAFCU have expressed their support for it. The major concern expressed has been that there be a phasein and, as indicated above, there is language in the bill authorizing that. In addition, in response to suggestions from credit unions, NCUA recommended that minor revisions be made to S. 2121 to assure credit unions that, if the recapitalization plan is adopted, there would be no double insurance premium, the 1 percent capital deposit would be refunded if NCUSIF is ever transferred out of NCUA, the liquidation payout priority provision affecting state laws be eliminated, NCUA would be required to submit an annual audited report to Congress regarding NCUSIF's operating level, and the title of the bill reflect that credit unions themselves are strengthening NCUSIF. These revisions have been made in the reported bill.

Another reason why NCUSIF's capital (.3 percent) is low relative to the FDIC and FSLIC (both approximately 1.3 percent) is that the FDIC and FSLIC each received initial capital from the Treasury Department. Thus, NCUSIF began in 1971 and has continued with premiums and investment income as the underlying sources of increased equity.

3. ELIMINATION OF TREASURY CHARGES OF PAYROLL ALLOTMENTS OF CIVILIAN FEDERAL EMPLOYEES

The bill would end the present fee of 6¢ per transaction which Treasury charges finanical institutions for depositing payroll allotments of civilian federal employees. The fee is not charged for federal military employees or for civilian employees overseas. Treasury supports this provision because the fee brings in less, approximately $2 million, than its costs to collect, about $4 million. Thus, in addition to removing a fee imposed on only certain federal employees, this proposal would save the government $2 million. This part of the bill is not controversial and all financial institutions support it. Moreover, the House passed the bill in 1982, although the Senate did not, and the House passed a similar bill, H.R. 3874, within the past few weeks.

4. BUDGET EFFECTS

The $1 billion being transferred by credit unions to NCUA to recapitalize the NCUSIF would, for budget purposes, be counted as reducing the federal deficit by a like amount (primarily because all NCUSIF funds are maintained in an account with the Treasury Department). (In addition to the $1 billion, it should also be noted that the $200 million which credit unions contributed to the CLF this past February also counts as a deficit reduction). If credit unions deposit growth continues, this amount would increase annually as credit unions maintain their 1 percent capital investment in NCUSIF.

The CLF tax exemption would result in $1.3 million in taxes already paid being refunded to the CLF. The effect of the refund would be to transfer the 1.3 million from the general Treasury to the CLF capital account at Treasury. CBO estimates that the refund would have no net budget impact.

The allotment fee elimination would result in an annual operating cost savings to Treasury of about $2 million. (This figure would increase if institutions, benefiting from the elimination of the fee, encourage more federal employees to use the direct deposit payroll system.)

With the relatively minor impact of the CLF and allotment fee issues included, CBO estimates that the overall impact of the bill would be a deficit reduction of $1 billion.

Mr. RIEGLE. Mr. President, I am pleased to rise in support of S. 2522. In my estimation, it is a reasonable and well thoughout approach to the needs of credit unions—that segment of the financial industry which remains dedicated to its tradition of providing credit through cooperative saving.

The three components of this bill address specific issues which, once resolved, will help stabilize and enhance the operation of credit unions throughout this country.

The first and perhaps most salient aspect of S. 2522 establishes a plan to strengthen the National Credit Union Share Insurance Fund, the fund through which the accounts of each credit union shareholder are protected up to $100,000.

Mr. President, those of us who serve on the Banking Committee appreciate those unique characteristics of credit unions which distinguish them from other institutions in the financial services industry. The National Credit Union Share Insurance Fund is one example of that distinctive difference.

Unlike the other deposit insurance funds, the credit union fund received no initial capitalization from the Federal Government. It is capitalized through premiums paid into it by participating credit unions and managed by the National Credit Union Administration (NCUA).

In 1982 expenditures of the fund exceeded income for the first time in its history. Although the fund was not jeopardized and the situation was temporarily alleviated by additional premium payments in 1982 and again in 1983, the condition pointed out the need for a more permanent funding arrangement.

The first provision of this bill represents that remedy.

I find it significant that this plan came to the Banking Committee by way of the credit unions. It is a responsible action designed to prevent a possible disruption to the fund by those credit unions who voluntarily participate to safeguard the accounts of their members.

In addition to raising the equity of the fund to 1.3 percent, the plan will improve credit union management by eliminating the burden of unpredictable double premium payments. Under this legislation, all insured credit unions will be required to maintain a 1-percent deposit in the share insurance fund. However, in recognition of the fact that credit unions have recently weathered one of the more stormy periods in their history, the NCUA Board has been granted the authority to extend the initial deposit period to avoid any adverse consequences.

This portion of the bill is responsive to the needs of credit union members as it strengthens the insurance fund. Yet, it is also cognizant of the condition of credit unions themselves by allowing the NCUA to tailor the initial participation period to the needs of each. Mr. President, as a member of the Banking Committee, which unanimously reported this bill to the floor, I commend the authors of this bill, Senators **Garn** and **Proxmire**, for their foresight in affording NCUA the flexibility to phase in the 1-percent deposit. I urge NCUA to use this authority freely. It is our intent that the 1-percent deposit be phased in so as to avoid undue or unnecessary hardship for the affected credit unions.

The second major provision of S. 2522 is one which clarifies the tax status of the Central Liquidity Facility (CLF).

In many respects, the CLF is to credit unions what the Fed is to banks. It is a source of favorable financing available for the short-term needs of credit unions. Unlike its counterpart, however, the CLF was inadvertently overlooked in tax legislation providing exemptions to this type of corporation. As a result, the CLF has accumulated a tax bill which the IRS is now looking to collect.

The retroactive effective date contained in S. 2522 will correct this discrepancy and will allow the CLF to operate free of tax liability as was the original intention when the corporation was constituted.

The final provision of S. 2522 removes the fees charged by the Treasury to financial institutions which receive payroll allotments for Federal employees. Eliminating this fee will improve government efficiency and will aid the Department of the Treasury in making full use of electronic fund transfer.

Mr. President, each of the provisions of this bill are well considered and will effect changes which will fortify all credit unions. I know of no significant opposition to this legislation and urge its immediate passage.

Mr. D'AMATO. Mr. President, I rise in support of S. 2522.

Many in this Chamber are aware that this year is the 50th anniversary of the signing of the Federal Credit Union Act. As we mark a half century of existence for Federal credit unions, it is significant that we are called upon today to consider legislation which will authorize a plan to increase the equity of the National Credit Union Share Insurance Fund.

The Federal Credit Union Act made the nationalization of credit unions a reality. Instead of being restrained in their service by State charter, the act gave credit unions the authority to follow the common bond of their membership across State lines. With this freedom, Federal credit unions have been able to provide services to their members throughout the world.

Today, 50 years after the enactment of that landmark legislation, we are being called upon to approve another credit union bill. Although S. 2522 does not possess the profound characteristics of the National Credit Union Act, it does contain several provisions of significance to Federal credit unions and their members. It is likely that this legislation will substantially effect the operations of credit unions during the next 50 years.

Clearly, the most significant aspect of S. 2522 is the positive impact it will have on the National Credit Union Share Insurance Fund.

The Fund, which is managed by the National Credit Union Administration (NCUA), is unique from other federally administered deposit insurance funds such as those of the FDIC or the FSLIC in that it received no initial capitalization from the Federal Government. Revenue for the Fund is currently obtained from the contributions of participating credit unions. Yet, similar to the deposit insurance provided at other financial institutions, the National Credit Union Share Insurance Fund guarantees the accounts of credit union members up to $100,000.

S. 2522 contains provisons which will strengthen the fund. Instead of relying upon periodic premium payments as a source of capitalization, this bill requires all insured credit unions to maintain a 1.0-percent deposit in the share insurance fund. This plan will raise the equity level to 1.3 percent, a level comparable to that of the other federally administered deposit insurance funds.

Mr. President, I feel a point here deserves emphasis. The National Credit Union Share Insurance Fund was started by credit unions to insure the accounts of their members. Although it is administered by the National Credit Union Administration, no Federal funding has been involved. The plan embodied in S. 2522 came to the Banking Committee as a proposal from credit unions themselves, motivated by an interest to raise the equity level of the fund.

Like many financial institutions, credit unions have recently been through a difficult period. Perhaps the proposal to strengthen their insurance fund is reflective of that experience. It was certainly something the Banking Committee recalled as it considered this legislation.

In S. 2522, regarding the capitalization of the insurance fund, there is a provision authorizing the NCUA Board to extend the initial time period in which credit unions would have to place 1.0 percent of their deposits in reserves. It is the clear intent of this provision that the 1.0 percent deposit be phased-in where necessary; any other arrangement might result in hardship for the affected credit unions. I would commend NCUA to take note of this provision and anticipate to use its authority freely.

Just as we must remain responsive to the needs of credit union members by legislating a plan which will bring stability to their insurance fund, we should also direct the Agency administering this fund that no precipitous steps should be taken to achieve the 1.3 percent equity level if an alternative plan is available which will alleviate any difficulty for the credit unions themselves.

Mr. President, as a member of the Banking Committee, I commend Senators GARN and PROXMIRE for their diligent work on this bill. It is responsive to the needs of both credit unions and their members.

This bill was unanimously approved by the Banking Committee, and I hope the full Senate will take similar action.

Mr. CRANSTON. Mr. President, I rise in support of the leadership's amendment containing identical language to S. 2522.

This is a good piece of legislation because it will improve the future stability of the National Credit Union Share Insurance Fund—the Fund which insures the accounts of credit union members up to $100,000.

As a member of the Banking Committee, I must commend the chairman, Senator GARN, and the ranking minority member, Senator PROXMIRE, for their efforts in bringing this amendment to the floor. In my opinion, S. 2522 is characterized by foresight and realistic good judgment.

The amendment is forward thinking in that it proposes a plan to bring permanent stability to the Share Insurance Fund without the prompting of a crisis situation. Under the present arrangement, the Fund is capitalized by periodic contributions from participating credit unions. Although the Share Insurance Fund is administered by the National Credit Union Administration (NCUA), it receives no funding from the Federal Government. During recent years, demands upon the Fund have necessitated that the NCUA levy double premium payments upon member credit unions. Instead of continued reliance on an increasingly irregular system of periodic payments, this bill requires all insured credit unions to maintain a 1-percent deposit in the Share Insurance Fund. As a result, the equity level of the Fund will be increased to 1.3 percent, which is comparable to that of the other federally administered deposit insurance funds.

S. 2522 is also characterized by a quality of good judgment. As those of us who follow the financial industry know, credit unions have recently been through some trying times. For this reason, some do not as yet possess the capital liquidity necessary to immediately deposit 1-percent of their assets into the Share Insurance Fund. The amendment before us has included a provision that will enable the NCUA to accommodate credit unions which might have difficulty meeting a 1-percent deposit requirement. It is the clear intent of this bill that the 1-percent deposit be phased in over an extended period of time where necessary. The NCUA should not hesitate to use this authority.

Mr. President, this amendment is responsive to the needs of credit unions and most importantly responsive to the concerns of their members. I urge the Senate to vote favorably.

Mr. GARN. Mr. President, the Banking Committee reported S. 2522 on April 2, 1984, dealing with recapitalization of the credit union share insurance fund. I thought it would be useful to include in the RECORD comments supportive of the plan which I have received in the last few months from two associations for credit unions, the National Association of Federal Credit Unions (NAFCU), and Credit Union National Association (CUNA). I ask unanimous consent that these letters from those two associations be printed in the RECORD in full.

There being no objection, the letters were ordered to be printed in the RECORD, as follows:

CREDIT UNION NATIONAL
ASSOCIATION, INC.,
Washington, D.C., February 28, 1984.

Hon. JAKE GARN,
U.S. Senate,
Washington, D.C.

DEAR SENATOR GARN: This letter has two purposes: (1) to thank you for recommending to Senator Dole that the Senate Finance Committee not consider taxing credit unions at this time and (2) to reiterate that with the changes in S. 2121 that you announced today CUNA unreservedly endorses this legislation and supports your efforts to assure its prompt passage.

Enactment of S. 2121, the bill to capitalize the Share Insurance Fund, is a priority matter for the credit union movement, which has been discussing how best to meet its long-term capital needs for nearly five years. CUNA formed the National Credit Union System Capitalization Commission for this purpose in 1981. In April, 1982, the National Credit Union Administration, after lengthy consultation with credit unions, formally adopted a policy goal of raising the equity of the Share Insurance Fund to the 1% operating level set by Congress. CUNA, too, endorsed this goal and thereafter set about studying plans for its attainment, including the one detailed in S. 2121. CUNA sent its 17,898 affiliated federal and state chartered credit unions a special background paper explaining the legislative proposal. It was examined at league and chapter meetings and discussed with the more than 1,000 credit union executives who attended CUNA's recent Governmental Affairs Conference.

NCUA also devoted its resources to making certain that credit unions understood the proposal and had ample opportunity to comment upon it. The agency produced a video tape on the plan and sent it to all 50 credit union leagues, trade groups, its six regional offices, its examination force and any credit union that requested a copy. In addition, the agency mailed the managers and boards of all federally insured credit unions a letter requesting that they verify the plan's impact on their individual credit union's balance sheet. Over 1,800 credit unions responded to this mailing, and the overwhelming majority endorsed the plan.

This review is meant to underscore that the capitalization plan has been thoroughly discussed with credit unions and that it has broad based support at the grassroots level as well as among credit union leadership. We hope that Congress will enact S. 2121 quickly so that credit unions can get about the business of putting the capitalization plan into operation.

Yours sincerely,

HAROLD T. (TOM) WELSH,
Chairman.

NATIONAL ASSOCIATION OF
FEDERAL CREDIT UNIONS,
Washington, D.C., March 19, 1984.

Hon. JAKE GARN,
Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: During testimony on S. 2121 before your Committee on February 28, 1984, I reported that the National Association of Federal Credit Unions was surveying membership as to their desires, concerns or recommended position on this important legislative proposal. You commented that day that you hoped we would continue to review proposed changes with our membership and "communicate to the Committee what their feelings are."

We are satisfied at this time that sufficient membership response has been received to give us a positive position on the bill. NAFCU's membership supports the capitalization of the share insurance fund as proposed in S. 2121. There is enough concern expressed by our members, however, for the NAFCU Board of Directors to ask for a phase-in of the capitalization. This would allow time for credit unions to liquidate or adjust investments and to plan their cash flow to provide the amount required to further capitalize the NCUSIF.

Fortunately, S. 2121 includes a provision for a phase in. It states:

"The Board (NCUA) may, in its discretion, authorize insured credit unions to initially fund such deposits over a period of time in excess of one year, if necessary to avoid adverse effects on the condition of the credit union."

NAFCU's Board, acting for its membership, asks for a three-year phase-in for all credit unions. Such an arrangement would infuse approximately $270 million in new capital into the NCUSIF in each of the next three years. This would reach the goal of capitalizing the fund at 1.0% of insured shares above the present equity of 0.3% of insured shares in a manner less burdensome than would be a single deposit. At the same time, credit unions would help to reduce the federal deficit each year at a rate nearly three times the amount anticipated in recent proposals [illegible] tax credit unions.

We are pleased to support the legislation that will make the NCUSIF stronger than ever. We applaud NCUA for developing this bold and straightforward plan. We also thank you, Mr. Chairman, for your continuous interest in a strong credit union system in the United States. Your foresight in offering S. 2121 at this time is commendable.

NAFCU stands ready to offer all assistance we can to see that S. 2121 becomes law of the land with those conditions we have asked for being fully considered.

Sincerely,

JOHN J. HUTCHINSON,
President.

The **Chairman**. I think we may go in the order because the opening statements all around were quite brief. I think that will give us time to work the questions out as we go. Is that agreeable to the committee that we do it in that fashion? All right.

Let's start on down through then. First of all, let me ask you why aren't we better off financing this directly from the Treasury and getting the lowest possible interest rates out of the market? Why should we take a secondary step that would drive up the interest costs?

Mr. **Darman**. Well, I would say that there are at least three reasons that seem to me relevant.

REASONS FOR NOT FINANCING RESCUE THROUGH THE TREASURY

One is that under our proposal that we have private payments that would defease the obligation to repay principle and that seems to me a plus associated with this. You could argue that you could get those private payments anyhow and use them for some other purpose, but that's speculative. We at least know that we have some degree of agreement on this approach.

Second of all—and this is from my parochial perspective—I think that Gramm-Rudman-Hollings is something to worry about. If we were to do this in a way that would adversely affect the budget deficit as recorded for purposes of Gramm-Rudman-Hollings, we would create a larger financial problem beyond this problem because I think it could well bring the political system to stalemate or certainly a period of prolonged confusion and debate as we attempted to deal with the Gramm-Rudman issue and the larger deficit issue. The net effect of that could be to drive interest rates higher, force us into recession and the adverse consequences would include exacerbating this problem, the S&L problem, driving up its cost, and of course creating larger costs throughout the economy.

Finally, I would say—and this is more in the nature of an academic or speculative point—it's not entirely clear that the cost would be lower with Treasury financing. First of all, it depends on what assumption you make about the way in which Treasury would finance it directly, and what is happening to the yield curve. Right now we have an inverted yield curve. If you assume the existing portfolio mix of Treasury debt, the average maturity is about 6 years. If we looked at the current Treasury rate in the marketplace for 6-year money—I think I've got the number here—I think it's 9.3 percent today, assuming something hasn't happened in the last hour or two. Of course if we were to do it all long, the assumption is that the rate would be, if it were at today's rate, 9.2, perhaps lower.

So it depends on what assumption you make about the way in which Treasury finances it.

The **Chairman**. I understand I think the rationale that you're offering, but I think most experts would say that if you finance directly using the Treasury rather than an indirect financing, you're going to get a lower interest rate.

Mr. **Darman**. Yes, but all I am suggesting, Senator, is that that isn't the only consideration even under this heading. I know that there's been testimony and some argument about what the difference in spreads would be, but that's comparing 30-year instruments and there's an argument is it 15, 25 basis points or a little more than 25 basis points difference. There's no doubt there would be some difference. But the question then is, what assumption do you make if it were all financed by Treasury.

I personally don't believe that Treasury would likely change the overall mix in its portfolio. So you have to assume that the average cost to Treasury is going to be something like the 6-year cost and the 6-year cost at the moment is higher than the 30-year cost.

The CHAIRMAN. I think you will get other questions on that this morning from me and others. I want to get to one other issue in my first time period.

As I understand it, the economic assumptions that are in this package are based on standard OMB projections that are in the budget. Is that right?

Mr. DARMAN. Yes, that's correct.

The CHAIRMAN. OK.

Mr. DARMAN. Of course, some of the assumptions are not in the budget and are not standard, but with respect to the general macroeconomic ones, yes.

The CHAIRMAN. Let's take a couple of those. You mentioned interest rates and obviously the question of the real cost of this plan is acutely sensitive to the level of interest rates.

As I understand it, the projection that's built into the plan—let me just take two interest rates specifically—the 3-month T-bill rates—you show those dropping from 8.2 percent where they were at the end of 1988, in the calendar year 1989 6.3 percent, then dropping to 5.5 in 1990, 4.5 in 1991, 4 in 1992, 3.5 in 1993, and 3 percent in 1994. I can't find anybody other than OMB that thinks that's realistic, but nevertheless that's the projection that you've built into the estimate.

On the 10-year Treasury rate notes, you have them dropping from 9.2 percent at the end of last year to 8.3 this year, 7.2 next year, then down to 6 percent, 5 percent, 4.5 percent, and then 4 percent in 1994. I would love to see 4 percent interest rates in 1994, and I would also like to see these lower rates closer in as you forecast.

I am frank to say to you I can't find anybody that agrees with those estimates. They are outside the range of virtually every other forecast.

If you happen to be wrong on these, if the rates are higher, how much does that start to swing the total cost of this package? I think Senator Shelby said for many of us in an exceptionally well-focused way, we want to make sure that the money we provide is going to be sufficient to get the job done. If we get interest rates that are not nearly as favorable as those you forecast, have you done a sensitivity analysis? Might that lift the cost say in the first 10 years as much as $5 billion, $10 billion, $15 billion? What can you tell us about that?

INTEREST RATE ASSUMPTIONS

Mr. DARMAN. Thank you, Mr. Chairman. Could I make a few points and respond to the exact question? You said the OMB assumption or anyone outside of OMB. I might note that this is not peculiarly an OMB assumption. It's an administration assumption derived from the CEA, Treasury, and OMB, and in fact derived from the prior administration.

What we have said is that we intend to revise this forecast at midsession, that we are using it for purposes of our budget presentation at this stage. We do not have something that we are saying we have absolute confidence in as a forecast. I certainly am not. I think it's a highly fallible business. I've also stated publicly and many times that I believe the interest rate forecast for the outyears is optimistic. I agree with you it's on the optimistic end of the range. I don't think you can compare it with most outside forecasters, however, because most of them don't make long-range interest rate forecasts, and that's probably sensible but we are obliged to.

Our record and CBO's record over the 1980's is consistently closer to each other than to being correct.

By the way, the direction in which we've been wrong over this period in interest rates is we have generally been insufficiently optimistic—we, that's that larger collective we—so it's quite possible to be wrong, indeed it's almost certain we're wrong, but it's possible to be wrong in both directions and the recent pattern on interest rates has been to be wrong by being too pessimistic.

Finally, on your point, which is a very important point, the cost of varying interest rates. I would expect that most outside experts would suggest—it's certainly my view—that interest rates are probably the most important variable in estimating what the size of the problem may be and the cost, however measured, of addressing it over time.

There are many, many other variables as suggested, but it's an extremely important variable. We have done some sensitivity analyses. We'd be more than happy to do others if the committee would like.

On our runs, if interest rates were 100 basis points higher than we have assumed, the "problem size"—I suppose we will come at some point to the question of what in the world does that mean, there's certainly been a lot of argument about that—the number comparable when people say $90 billion, that number would rise by about $5 billion in our estimate. If it were 200 basis points, it would rise by about $10 billion. But that's if the only effect we were dealing with were an interest rate effect.

Obviously, if you assume that the interest rate effect would have adverse effects, as it may well, on other elements of the economy, then you have to start making adjustments for that as well.

There's another effect of an interest rate increase which is not just on the "size of the problem." It would be on the outlays that we would estimate to be associated with implementing the plan as we have proposed it. For that, if there were a 100 basis point increase, the outlays would be as we estimate them up by $1.8 billion over the 5-year period 1989 to 1994; they would be up by $5.2 billion over the 1989 to 1999, the 10-year period. So the $5.2 includes the $1.8.

There is a small offset of $400 million that you would save because if you have higher interest rates the zeros can be purchased for less. The zeros that are covering the principal, that are defeasing the principal, could be purchased for less. So that's about a $½ billion that would be freed up that at least in principle would be available from the private side to offset these increases I mentioned.

If we were off by 200 basis points, these numbers are roughly—they are not exactly linear but one shouldn't have that much confidence anyhow, in my opinion, in these—$3.9 billion for the 5-year period would be the adverse outlay effect, $10.7 billion over the 10-year period, so that includes the $3.9. And the offsetting savings from the lower amount required to purchase the zeros would be about $700 million.

So if our assumption was off by 200 basis points, over the 10-year period, it would be something on the order of $10 billion, which on average would be $2 billion a year in terms of order of magnitude.

I personally think that while these are important and significant numbers, we won't be able to get reliable and responsible closure on what is the right interest rate number to assume. What I think we can assume is what several senators said in their introductory comments and that is, the sooner we get about the business of fixing this up, the lower the cost will be, partly because of the favorable interest rate effect that comes from cleaning this up.

And I would just add, again from my OMB perspective, that I think it's also true that the sooner we do the larger deficit reduction package, the better off we will be under this heading and many other headings. And there, I would say that the Chairman of the Fed is a highly relevant witness. Though our interest rate assumptions for the outyears are I think optimistic, the direction of having them come down rather sharply is one that he affirms. He says if we were to get a relatively prompt budget agreement of the type that we're talking about, he would expect to see interest rates coming down sharply. And all our forecasts on this subject are highly conditional on that assumption. We would not be forecasting such interest rates in the absence of a relatively prompt agreement on deficit reduction.

The CHAIRMAN. Thank you. That's very helpful to get that answer on the record.

Mr. DARMAN. I guess I should apologize.

The CHAIRMAN. Senator Garn.

Senator GARN. Well, you didn't waste the time because it was in response to my basic question in my opening statement. So we killed two birds with one stone in any event.

I also used some numbers in my opening statement describing the administration's plan as providing $83 billion for the RTC and the new SAIF insurance fund. In your opening statement you define the resolution cost as between $80 and $110 billion and there has been some confusion over how your numbers were derived and their relationship to the so-called size of the problem.

Could you break down your estimate into old cases, RTC cases, and SAIF cases and show how those elements compare to the funds provided in the plan?

BREAKDOWN OF THE COSTS FOR RESOLVING THE PROBLEM

Mr. **Darman**. Yes, Senator, I could. I might just note before answering that that you also said you thought—well, perhaps you'll get to this, about the interest costs being misleading and so on.

Senator **Garn**. Well, I thought you answered that rather adequately in response to the chairman's question.

Mr. **Darman**. Well, in a way they are interrelated because there's been an awful lot of talk—by the way, I don't think that I have yet contributed to this and I would like not to—about what is the "size" of the problem. I have so far only used one number and maybe from my parochial perspective I would hope to get away with it. And that is, what's the effect, bottom line, on the budget. And I've said that is estimated to be on the order of $40 billion over the 10-year period.

But switching to the terms that other people like to use, there is a problem. When people talk about the "size" of the problem, they are frequently talking about a set of about 506 insolvent cases and what they estimate, roughly speaking, to be the present value of the infusion necessary to resolve those cases by one means or another.

They do not include financing costs when they use those numbers. I think it's by the way appropriate not to use financing costs if we're trying to be comparable with the way we look at other things in the budget. But the set that they use, the 506, includes cases that have already been resolved, old cases, some of which have already been fully paid for, some of which haven't. Then for "new" cases, and more recently with the Treasury's analysis which I think is correct, they have also included future expected problems, future insolvencies, not current insolvencies, that need to be budgeted for as we look ahead in a steady state world where there's still going to—though there isn't a crisis, there's still going to be some insolvencies.

So I think the Treasury numbers, to try to relate them to yours, would be on the order of $40 billion for old cases, on the order of $50 billion for additional cases part of the current crisis to get that whole set resolved, and then you're right, an additional $24 billion for expected future insolvencies over a 10-year time period.

That last number, $24 billion, is not used in most people's estimate of "the problem", but I do think for analytical purposes we have to include that number as well if we're trying to look at what the 10-year set of flows would be and what the 10-year financing costs are.

Now trying to track this back to my numbers, we assume $40 billion for the old roughly, some of which has already been paid for, some of which hasn't; $50 billion for the remaining cases from the original 506 crisis pot; and then in a new world, 1991 forward, where we've got a relatively more healthy and stable and growing financial services sector, $24 billion. All of that is assumed in the numbers that get us back to an outlay effect over 10 years of $39.9 billion.

What we want to call the problem, in my opinion, is not really all that constructive a debate. We could get into it, but you could define the problem as $40 billion, $50 billion, $90 billion, $120 billion, $140 billion, $150 billion, $160 billion, $170 billion. It depends on what you count. And I'm happy to count all these things and am prepared to try to help do so. It's definitional, which one of those numbers you want to pick and call "the problem." One way or another, it's all got to be financed.

Senator GARN. Well, I could not agree with you more. Last summer we held hearing after hearing and in most of the hearings we debated about what the size of the problem. I made the comment then that what was important was getting on with the solution, because nobody's numbers were correct and, as you indicated earlier, it really didn't make any difference whether it was $90 billion or $120 billion. It was one big problem and is a much bigger problem now, and we ought to get on with it.

What I'm trying to establish is at least a generally common base from which we can work and move to a solution as rapidly as possible.

Mr. DARMAN. Could I add one comment?

The CHAIRMAN. Please.

Mr. DARMAN. I'm sorry, Mr. Chairman, but I think it's necessary to help try to clear this up, even though it might not seem to be.

As you know, Senator Garn, perhaps better than I—these are of course estimates. The $40 billion piece is an estimate. It depends on a lot of things. Some of it is already known, but some of it remains to be determined. The $50 billion, which is the estimate for the cases yet to be done that are still in the crisis definition, that I think has been relatively conservatively estimated. I mean to say I think that you can defend the proposition—treating Senator Shelby's concern and others—that that $50 billion has a margin to spare within it. In other words, a lot of the conventional estimates of what would be the cost of that piece come in at the range of $35 billion to $42 billion or $43 billion, and we are assuming a fudge factor or a slippage factor in there of about the difference between the $35 billion and the $50 billion. Now this allows room in our model for adverse interest effects, but lots of things can change and the fudge factor is a pretty decent size one, defining the problem on the order of $10 billion more than most of the conventional analyses would say for that set.

The CHAIRMAN. Thank you, Senator Garn.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Darman, the first thing I want to do is to thank you for your candor before this committee. When you—I believe I'll paraphrase you—said you had not arrived or your office had not arrived at these figures in a linear fashion, and I think that's important because a lot of us that have served in the House before we came to the Senate and the people who have served over here for a number of years understand these budget assumptions and some of them have been so lowball in the past that we've had problems of credibility. You coming before the committee today with your candor is really refreshing to me.

Now after having said that, some of the assumptions—the assumption of a 7-percent growth rate or thereabouts in the savings and loans or the savings institutions, I hope that comes about, but then what's this silent run which we're going through now, have been going through with the exodus of the deposits? How do you believe this will come about that so much confidence is restored, especially when in the private sector they might get a half a point more yield? Is that a factor? Or once they move their money out, say your average "Joe Citizen" in my State of Alabama or anywhere else, and they feel comfortable that they've moved $100,000 into a mutual fund or a private fund of any kind and there's no run there and there's no danger that they know of and they're getting a half a point yield or a little more. What then?

RESTORATION OF CONFIDENCE IN THE SYSTEM

Mr. **DARMAN**. Well, I don't have the up-to-date statistics on how much of the money that has been withdrawn has gone into something other than banks, which would be the relevant number to take a look at. But I would be surprised if a large portion of it had gone into uninsured funds, because the psychology of somebody who's pulling their money out is somebody who is concerned about the safety, soundness and so on.

Senator **SHELBY**. Can you get some figures on this, if they're moving it from the thrifts to the banks?

Mr. **DARMAN**. We can try. OMB wouldn't have them, but we can get them. We'll try to get them. The Federal Reserve System and others will have it, but I'm not sure that it will be as current as you would like.

But let me try to deal with the point from a little bit different perspective because you introduced the subject with the question about the 7 percent assumed growth in deposits.

That is not out of line with what the pattern has been over the past 10 years. The question is, can we get this resolution moving quickly enough so that confidence is restored so that this industry is stabilized, so that people are willing to go back to the pattern of investment that they seem to be retreating from a little bit at the moment?

I think it's generally assumed that if there is a responsible fixup program that there will be a return of confidence and there won't be a major shift in the pattern of people's savings.

If that's the case, it's appropriate to look at what the historical rate has been and over the past 10 years it has been, in terms of deposit growth, an average of 8.81 percent. And our estimate, as you know, is about 7 percent. If you were to include the Federal Home Loan Bank advances in the calculation, the average growth rate would be 9.33 percent over the past 10 years, again compared with our 7 percent.

By the way, 7 percent also compares fairly well with the growth in nominal GNP.

If someone wants to say that they expect the number to be much lower than 7 percent, they have to be assuming that this sector is in significant decline. And I would have thought that the point of the reform legislation would not be to put the sector into significant decline.

Senator **SHELBY**. But to restore public confidence?

Mr. **DARMAN**. Right.

Senator SHELBY. One other item. You mentioned a few minutes ago $24 billion for future failures, in other words, looking down the road to the second or third tier of this problem.

Mr. DARMAN. That's what our numbers assumed over a 10-year period beyond the crisis set of insolvent institutions that is usually looked at.

Senator SHELBY. We're talking about in the bill moving thrifts' capital base from 3 percent to 6 percent. Some of us are concerned that some of the thrifts might not be able to make it to 6 percent all at once but if they were healthy and growing in the right direction that they should have some leeway, say they go from 3 percent to 4 percent and 4 percent to 4.5 percent and 4.75 percent and a movement in the right direction. I raise that point because if we have an arbitrary 6 percent capital arrangement all at once that could tend to cause a lot more thrifts to be closed and more money to be paid out, could it not?

Mr. DARMAN. It could if it were administered clumsily. But I believe it's our assumption that the insurer would have a degree of discretion, and we would expect that that discretion would be exercised intelligently so that an institution which was on a path toward meeting the requirements, and it had a reasonable prospect of meeting the target, wouldn't be thrown into insolvency if it had a reasonable chance of surviving.

I think it might be helpful if I told you what we've assumed, more or less exactly, in this. There are now I think 1,827 thrifts that meet the FDIC minimum capital requirements, that already do. At the other end, there are 345 that are insolvent at the moment which we are assuming are going to be subject to the resolution. So the group that we're talking about is the group that's in between. This group is about 780 on my numbers, thrifts that are GAAP solvent but below the FDIC minimum capital requirement at the moment. We assume that something on the order of 170 of those will by 1991—which is the trigger date I think you're concerned about—that they will meet the FDIC minimum capital requirement.

At the other end, we assume that there are about 200 that will not, and will fail, and that they would fail with or without the capital requirement. They're in trouble.

Senator SHELBY. They're going either way.

Mr. DARMAN. They're not the in between batch you're concerned about. The in between batch that you're concerned about is on the order of about 400 that would need new outside capital in order to make it. And if the solution is a responsible solution, we believe the degree of outside capital would flow.

To the extent that that weren't sufficient, the insurer would have to make a judgment. And it's in that area of judgment and the exercise of that responsibility that you would hope and expect that institutions that have a realistic prospect of getting there would get a chance to get there.

Senator SHELBY. Some of us want to make sure there's sufficient legislative leeway written in for the regulators.

Mr. DARMAN. Yes, sir, but I would think that we should be very concerned if there were something written on that subject.

Senator SHELBY. Be very careful about how it was written?

Mr. **Darman**. Because the last thing you would want to do would be to create a—not the last thing but certainly one pretty far down the list—you wouldn't want to create such an opening there that the problem just continued in the form that it's been all along here with a bunch of basically not viable institutions spoiling the market for everybody else.

Senator **Shelby**. You're totally right.

Mr. Chairman, thank you for your indulgence.

The **Chairman**. Thank you, Senator Shelby.

Senator Bond.

Senator **Bond**. Thank you, Mr. Chairman.

Mr. Darman, some of us read scholarly articles by economists, one of whom is making the argument that really we should just finance this out of the Treasury and since the loss is already on the books just skip Gramm-Rudman and just write it out of the calculations.

It seems to me that there's another aspect of this in that if you finance it out of the Treasury the Federal Home Loan Banks don't have to come up with the money for the zero coupon bonds and it would seem to be a special benefit for the healthy S&L's. I'd like your comment on that.

I'd also like to go a little bit beyond that and ask you for your comments on the relative burdens between the taxpayers and the industry. If interest rates rise on the one hand or, on the other, perhaps a combination, if we have a recession, is the system set up now so that the Treasury really bears the full burden? Should there be some greater contribution built in from the industry if the cost is larger? How would you explain for us the relative burdens on the industry versus the Treasury should the basic economic assumptions change?

HOW ECONOMIC CHANGES COULD AFFECT BURDENS ON INDUSTRY VERSUS TREASURY

Mr. **Darman**. Yes, Senator, I'll try.

First, on your Gramm-Rudman point, I believe you're correct when you said that. In addition to that, there is an argument to be made that under this system one does get, at least arguably, more private participation. The counter-argument that could be made of course is that since that private money is there someone could figure out a way to get that same private money somehow or other allocated but it would of course require the agreement of the parties to the overall system. This plan is at least one that I think has a viable chance of getting that degree of private contribution and I don't know of an alternative that does at the moment.

Now over the longer term, you're right, in what I took to be the implication that if things go badly, the taxpayer is the one who's going ultimately, one way or another—or the citizen—to have to bear the burden. It's not shared proportionately with the industry.

The way in which this financing system has been derived makes that almost an inescapable characteristic. The way in which it's been derived is to start with an analysis which says we know roughly what the size of the problem is and by anybody's definition it's beyond the industry's ability to pay. So now the question is, how do we estimate what is the maximum amount you think is reasonable to try to get the industry to pay without going to the point where you're taxing it in effect in order to destroy it.

Now it's subject to some argument what that point would be, but a lot of people think that this plan is already pretty near the outer limits of that. Certainly the people in the industry are inclined to that point of view.

Once you answer that question and you say we're going to exhaust that resource, we'll take all of that first, the rest—I don't know what other source there is—unfortunately it comes back to the public sector, and the public sector obligation is already there. It's not some new obligation. The insurance already exists and the question I think you have to be asking is what's the maximum amount the private side can bear, because the remainder is already committed. There's an argument about how we're going to finance it on the public side, but the commitment is there in the form of the insurance.

Senator BOND. Following on with that, one of the things that's built in, in addition to the assumption that there will be a 7-percent growth in thrift deposits which concerns me a little, is an assumption that throughout this period the increased FDIC premiums on banks will not raise the reserve of the FDIC to the level of 1.25 percent.

Should that 1.25 percent goal be reached, there would be a provision for either rebates or decreasing the premium. Is it likely that the banks would reach that 1.25 percent and, if so, what would be the effect on the budget, what would be the effect on the competition between banks and savings and loans, and where would you see the S&L premium being at that point?

Mr. DARMAN. Well, I don't think that on our assumptions—I'll just check this if you would permit me—on our assumptions, I don't think that you get to the 1.25 percent until the 21st century, but if you'll just hold one second I'll check that.

We don't get there by 1999. How soon in the 21st century we might get there is something we don't have an exact estimate on. But we don't get to the 1.25 percent on these assumptions until roughly the turn of the century.

On the question of the competitive effect, I think this does move in a favorable direction from the standpoint of competitive effect for S&L's because quite obviously the difference between the premium paid by the S&L's and the premium paid by the commercial banks to the FDIC is closing and that's a desirable characteristic I think of any long-term solution, that those should be much closer together so that the adverse competitive situation from the standpoint of S&L's is reduced.

Senator BOND. Thank you, Mr. Chairman.

The CHAIRMAN. I think those were very important questions. If I could just ask for one clarification on one issue. I think you've made it very clear that the industry under the plan is being asked to contribute as much as the administration believes it prudently can and the rest the taxpayer has to pick up.

Is it also true that the ultimate claim to the taxpayer, the way the package is structured, is essentially open-ended? No one quite knows what the ultimate size of the package will be, but in effect, we've put no outer limits on it. So, the figure will turn out to be whatever it is. But isn't there, in effect, through this SAIF fund a blank check that we would be signing that says the taxpayer will pick up the residual no matter what the amount is?

Mr. **Darman**. It is a small point if I might, Mr. Chairman, when we use the term the "taxpayer," I'm not sure we're using the right term.

The **Chairman**. Well, the U.S. Treasury.

Mr. **Darman**. Or somehow or other the citizenry. The burden can be borne in inflation and in a lot of ways other than taxation, but if you mean somehow or other the nonbanking portion—the rest of the system, the public—yes, given that the obligation is already there, the insurance is already there. If somebody were proposing to remove the insurance system, which we're not and I don't understand anyone on the committee to be proposing that, then you wouldn't have that problem. But it seems to me as long as you've got that characteristic, then we're dealing with estimates.

And what is the estimate of the outer limit? We don't have a formal way to cap it if we mean to honor the commitments that everybody, I think, assumes are going to be there on the insurance side.

The **Chairman**. If I may just say before yielding to Senator Bryan, listening very carefully to what's been said it sounds to me that if we were to pass a package just absolutely as is we sign up for that future cost no matter what it is. It may be higher, it may be lower, it may come in close to where it is. We may want to think about establishing an outer limit on it so that if we find that for some reason the calculations don't go right and the thing just spirals upward and upward that we have a way to force it back into our own hands.

Senator **Bond**. Mr. Chairman, I would say that I would love to be able to do that, but I think we've already signed up for the dance and it's just what kind of tune we want to play and if the thing goes off the charts we're dancing with them some way and I don't really know how we can put a limit on it.

Mr. **Darman**. Mr. Chairman, could I suggest that there are some safeguards. They are probably not sufficient to address your concern, but I don't know of any way you could fully address it.

There is, of course, the ability to raise the premiums. I know that that is argued about, but it could go up to 35 basis points. So some degree of the burden could be shifted in that direction over time under the proposal as submitted to you.

There's another couple of characteristics that I think are important. I gather there may be some disagreement even within the administration on this, judged by what I read about some testimony here. But I personally think it's desirable to have some cap on the obligation limit of the FDIC and the new funds and there is such a cap proposed in the legislation we submitted to you. I believe it's half of net worth for each fund up to $10 billion in each. And then beyond that, there is a $5 billion draw against the Treasury with the approval of Treasury. So you could think of it as being $15 billion.

Some number I think should be in there and I gather there was some testimony that said there shouldn't. I personally think that there needs to be at least some accountability in the system, not just in the hands of an insurer, but some accountability in the system that says as you start writing this paper and doing more and more of this obligating—not that that's not a good idea, it may be in certain circumstances, it may not be in others, however—we would at least like to have some check upon the rate at which this can start happening. It's a somewhat arbitrary judgment what number you're going to put on this and there should be appropriate flexibility in the hands of the insurer, but an appropriate check at the same time that says, look, if this starts to get way out of bounds we want to stop and review the bidding. And I personally think it's only common sense that there ought to be some sort of mechanism to slow the thing down and say, wait a minute, if we're getting way out of line here again, which we all hope we wouldn't be, but if we are, maybe we don't have the right conceptual approach. Maybe it's time to review the bidding and let's put another freeze on the system.

Now that's in a terrible worst case situation. That's assuming that what we would have done didn't work. And I think we are all designing this in the hopes that it will work. But it's virtually guaranteed that there's at least some probability that we would fail and it may be small and we hope it's small, but whatever it is, I think there should be some safeguard.

The CHAIRMAN. Thank you, Senator Bryan for your patience.

Senator BRYAN. Thank you very much, Mr. Chairman.

I, too, would like to join in with the comments made by Senator Shelby earlier. We really appreciate your candor, Mr. Darman. I think really what you're telling us under this plan, perhaps indeed under any plan, that ultimately the American public is going to be the deep pocket in terms of making up the difference between what the private sector is able to participate in.

I'd like to ask if you might make available to the committee without belaboring all of the numbers that have been discussed, to do a run on variations that you've shared with us this morning in part—you have in response to the chairman's question earlier given us an evaluation of what the impact is if interest rates are 200 basis points higher than the OMB projection.

I'm wondering if you might extend that and give us a number of variations that you could have your people run up for us and give to the committee 200 basis points, 300 basis points, whatever you think the reasonable scope of variations are. You've been very candid to say it's at best an estimate, one that you would consider I'm sure informed and educated, but there are some variables there. Would that be possible to do, Mr. Darman?

Mr. DARMAN. Yes, I'd be happy to. Maybe it would be helpful—could we work with whomever you suggest to just get a reasonable set of such alternatives?

Senator BRYAN. If the chairman would have no objections.

The CHAIRMAN. I strongly support the idea and I think in the positive spirit that we've had the discussion so far today we ought to be able to sit down and work through some sort of a sensitivity analysis that we can construct and both feel comfortable with so we can test some of the assumptions.

Mr. **Darman**. Could I mention one thing? I know you asked that we not get into the detail right at the moment and I think that's probably wise. We would be happy to submit this, but just to give you a feel if I could, since one other issue has come up, the sensitivity on the 7 percent growth rate for deposits. If you nearly cut it in half, if you drop it down to 4 percent, which I don't think would be a good sign in terms of our success in addressing this issue, but if you did drop it down to 4 percent, I think our estimate is it would increase the outlays on the order of $1.2 billion over the 1989 to 1994 period, the 5-year period, and about $4.7 billion over the 10-year period.

So it's an important number, but if we're anywhere close to the historical pattern over the next decade, that one isn't going to fundamentally affect the picture.

Senator **Bryan**. Mr. Darman, I know you will provide to our staff through your staff those growth rates of deposits as projected.

Let me try to get a little better understanding on the numbers you have provided us, $40 billion for the old, $50 billion for the additional cases, and $24 billion for those future insolvencies.

You enjoy here in Washington a preeminent reputation as a wordsmith, so I'm going to ask you to try to explain this perhaps in the idiom of the street, not the arcane language of accounting which is very difficult for the average citizen to understand and they are the people who we are representing.

Now the $40 billion which represents the old, are we talking in effect about the resolutions that were effected prior to the end of the calendar December 31, 1988?

Mr. **Darman**. That's right, yes, sir.

Senator **Bryan**. And in that $40 billion, are we talking about $40 billion that ultimately the American public—I know you refrained from using the term taxpayer—but allocate if you will by category, private versus public sector, how much of the $40 billion is allocated?

Mr. **Darman**. I don't have it broken down that way and I really don't think, with respect, Senator, that it's going to turn out to be a very profitable way to look at it. The funding flows for this are not divided—and I don't expect there will be a scheme under which they are divided—so that we say we're going to take this source—let's say it's private and we're going to make it pay for old cases for these categories of expense or outlay associated with old cases, and then we're going to say if that exhausts all private resources, let's say including future income streams for 20 years, that we're then going to take public resources for the next 50 years. It doesn't break that way.

The cases are all being worked on, in a sense, simultaneously and so you have to look at what is the total set of outflows you have to make for the old ones and the new ones, and then what are the available sources coming in, and in a certain sense they are fungible. Or to put it another way around, it's arbitrary if you decide to say that private will go to the old, and let's see if we can invent a scheme so we say 100 percent of the old is paid for by private and then some large percent of the next group of cases will be paid for by the public.

Senator BRYAN. But it's fair to say the $40 billion, the $50 billion and the $24 billion all represent a combination of private and public resources?

Mr. DARMAN. That's correct, but they don't include, for example, interest costs.

Senator BRYAN. Well, my time is up.

The CHAIRMAN. We have been running a little bit over and if you've got a follow-up question you want to ask I'm going to try to make an accommodation every time.

Senator BRYAN. Thank you, Mr. Chairman.

OBLIGATION OF PUBLIC AND PRIVATE SECTORS

In other words, as we try to unravel this, Mr. Darman, I think part of the frustration that a lot of us experience is that we understand this is extraordinarily complicated and no one here is expecting someone to come before the committee with precision to forecast what it's going to be like 10, 15, 20 or 30 years from now. On the other hand, there ought to be some way in which a man with the enormous erudition that you bring to this committee could tell us what portion of this is going to be public sector obligation or outlay, to use your term, and how much is private sector, and using your own numbers, not to be contentious or quarrelsome—the $40 billion, the $50 billion, the $24 billion—can you give us a ballpark?

Mr. DARMAN. Yes. In fact, Senator, I'd be happy to submit a breakout. I was only arguing with you, if you'll pardon me, on whether it really should be broken in exactly the way you said.

What I think is the useful way, if I could suggest—and I'd be happy to submit these tables—the useful way is to say what are all the outflows necessary over 10 years, 20 years, 30 years? What are all the inflows 10 years, 20 years, year by year and run those out. And then for each year just give you the percentage how much is public and how much is private. If that would be acceptable, we can easily do that.

The pattern will show that the public sector piece under our assumptions starts rising substantially in the outyears, the percentage does, mainly because what's left to be done in the outyears is heavily interest and the government is responsible for the largest piece of that interest. It's the residual. It's the backup for the interest and the private flows available to cover that interest are not assumed to be sufficient. So you see the percentage will be rising and I'll give you the exact numbers on our estimates if that would be helpful. I was only quibbling about whether you could break it by old versus new.

Senator BRYAN. Thank you.

The CHAIRMAN. I think that's helpful.

Senator Mack.

Senator MACK. Thank you, Mr. Chairman.

I want to follow on I guess with the numbers that were just being used and just clarifying again, the $40 billion that was referred to is to take care of the cases that were in essence solved last year?

Mr. DARMAN. Not just last year. There's an original set of I think 506 thrifts that were GAAP insolvent, of which there's something like 345 left after everything done through last year. So it's the difference between those. Not all of them were done last year. Some were done in the prior year.

Senator MACK. OK.

Mr. DARMAN. But from the time that the crisis was defined as a crisis, there was a set, defined as the crisis, of about 500 and all but roughly 350 of those through the end of last year have had some sort of resolution. So the $40 billion deals with that set through the end of last year that has had some sort of resolution, but they weren't all in last year.

Any maybe for further clarification, $40 billion, the reason it's not such a useful number even though it's been thrown around a lot, is on the one hand it doesn't include the financing cost, and by some ways of looking at things that's entirely reasonable. We don't look at financing costs for most of what the Government does, if we were being fair.

Senator MACK. I don't have any problem with that.

Mr. DARMAN. But the other thing is, of that $40 billion—this is another thing that tends to be a little bit confusing—mentally people tend to think when you say it's for old cases that the $40 billion is already out the door. The $40 billion isn't all out the door. Some of it is out the door. Some of it is yet to be paid as a function of yield maintenance agreements, asset support agreements and so on.

Senator MACK. But the allocation of the resources necessary to take care of the $40 billion have already been in essence taken care of. They will not come out of this new proposal that we're looking at.

Mr. DARMAN. That's not exactly correct, Senator, again for the same reason that I suggested with Senator Bryan. Since some of the costs——

Senator MACK. Separating the financing part of it.

Mr. DARMAN. Not just the financing, but some of the continuing costs of resolving the old take place over the next many years. And if it would be helpful to disaggregate—I think in fact we have disaggregated how those flows work. If we haven't, we can submit them, but I think we may already have done so.

If you would look at either attachment A or attachment B in the prepared testimony, I think you'll find the flows broken out by what are the remaining disbursements required for old cases. For example, if I could point you to attachment A, the old cases that are in that $40 billion, not all of which is already accounted for, some of which is a continuing cost. If you just look at the first set—it says "Old cases"—under disbursements, there will be continuing administrative costs associated with those old cases. There's the interest, that's the payment of the interest on the notes associated with those old cases. Those still have to be paid year by year. Then if you look on down the assistance payments, which is a fairly sizable number——

Senator MACK. What does that represent?

Mr. DARMAN. Those are the yield maintenance agreements and the asset support agreements, and those are necessarily an estimate. Some of the other lines are more certain, like the interest on the notes outstanding. Although there is some estimating in that, the terms of the notes are already set. The assistance payments, for example, depend upon the performance of the local economy to some degree because they're a function of the spread between what's being returned on the assets at the moment and the guaranteed level. So if the local economy comes back strongly, say in the Southwest, those payments would be lower than they might otherwise be.

In any case, those are estimates and they're a big piece of this estimate. As you can see, over 10 years those are $28.8 billion.

Senator MACK. Let me if I could just switch back also to the 7-percent deposit growth and tie it into the capital question. One of the things that has been told to us over and over again is that as we've raised the question about whether it's feasible to raise the doubling of the capital by 1991—and I don't want to get into the debate about whether or not 1991 is too early, but one of the alternatives to raising capital is shrinking institutions.

And I'm just wondering what impact, if you have to shrink institutions in order to get to the capital structure necessary, what impact does that have on deposit growth? I understand your point that by passing of the package we would restore confidence in the industry. What impact would occur because, again, possibly having to shrink institutions to meet those capital requirements?

IMPACT ON DEPOSIT GROWTH

Mr. DARMAN. That effect is already assumed in our numbers and I mentioned to you what specifically we're assuming about the set of thrifts that would not now meet the capital requirements. When you say shrinkage, I'm not sure what you would mean beyond that because the ones that already meet the capital requirements we wouldn't be trying to shrink those. So it's the other set. 345 of the remainder are insolvent and our assumption is that those are shrunken in the extreme—I mean those are resolved. And then the remainder is 780. We're assuming, as I said, about 170 of those make it across the hurdle. And we're assuming an additional 200 will fail with this shrinkage.

Senator MACK. Well, I'm not sure I understand. If the 170 will make it across the threshold, how do you do that? Are they going to be able to raise the capital in the market?

Mr. DARMAN. No, they don't need new capital to make it. They make it just by virtue of the fact that they are already fairly close and there are presumptions about their cost of money decreasing and other economic effects that allow them to make it over the line.

Senator MACK. OK.

Mr. DARMAN. The set in between I think is the problem set. There would be about 400 in that in between set and I don't think—I can just double check in a second—but I don't think that an assumption about what's going to happen to their growth rate is going to fundamentally affect the overall base. The whole set of 400 in question here has only 22 or 23 percent of the asset base. So if you were making an assumption about there being 1 or 2 percent difference in growth rate, or even less, than the 7 overall average, it's only going to be weighted by approximately one-fifth in terms of what it's doing to the whole picture. So I don't think it will turn out to be that significant.

Senator MACK. OK. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Mack.

Senator Wirth.

Senator WIRTH. Thank you, Mr. Chairman.

And thank you, Mr. Darman. You are, as ever, a very good witness. We appreciate your being here.

Let me just follow up first of all on a question asked by Senator Riegle on off budget-on budget.

S&L RESOLUTION ON BUDGET OR OFF BUDGET

You had three reasons for putting the S&L resolution off budget and one of those was Gramm-Rudman-Hollings. That is if we put it on budget in fact that would further stretch Gramm-Rudman-Hollings and might get us into a real crisis. Is that right? A real gridlock?

Mr. DARMAN. Yes. I wouldn't use the term on budget. I believe that our solution is on budget as well. It's not one approach is on and the other is off. It's that if you financed it differently, the amount that would be scored on budget would be higher.

Senator WIRTH. And one of the reasons for doing that and financing it in a different way, which some think is going to be more expensive, is that by financing it in a different way, you are going to increase the potential of coming to a conflict between the Congress and the executive branch over Gramm-Rudman?

Mr. DARMAN. That's right, and I think that that in turn has a number of very adverse effects on this problem and on the economy.

Senator WIRTH. Does that suggest that—I'm on the Energy Committee as well and one of the problems that we have is the other Christmas present that was left for you, which is the nuclear weapons complex and what to do about that. Should we be figuring out a way to take the nuclear weapons complex and finance the fixing of that and put that off budget as well? I'm looking for the consistency in the approach of being on or off budget.

Mr. DARMAN. Right. May I mention two important differences between these cases? You're right, that's another present which I wouldn't have minded if someone else had handled.

The pattern of expenditure required for the nuclear cleanup is one that most people would say would best take place over a much longer time period. The pattern of expenditure for the thrift industry, the optimal pattern, requires a big infusion of funds. As you know perhaps better than I, in the cleanup area, we are proposing to spend almost all that anybody has suggested be spent in year one and two from here, because until you do certain studies, including epidemiological studies and other kinds of tests and engineering studies, you don't even know what the expenditures are going to have to be or what priority, when, where and so on. So those expenditures tend to have a pattern that goes like this [indicating]. It grows exponentially but it starts fairly slowly.

This one is the opposite. This one has a pattern that goes like this [indicating].

Senator WIRTH. I hope that's correct and in fact as we look at the budget for the nuclear weapons complex in fact that's going to show over a long period of time the fact that you do have that balloon that comes in the mid to late 1990's.

Mr. DARMAN. There's a second difference, Senator, and that is that in this case there is a set of private parties who are legitimately being asked to pay because they are the beneficiaries. They are paying insurance premiums for insurance received, maybe not fully paying for what they are receiving, but they are paying up to what we think is the maximum they can bear.

In the case you cite, of course, you don't really have the option of designing a system where private payors would have the responsibility because the user——

Senator WIRTH. It's difficult to finance a nuclear weapons complex now.

Mr. DARMAN. But there isn't a set of private payors where the Government is the user.

Senator WIRTH. Let me jump to another issue. The $40 billion for resolutions in 1988, does that $40 billion include revenue forgone?

Mr. DARMAN. Revenue forgone under what heading?

Senator WIRTH. Tax losses?

Mr. DARMAN. Yes, it does.

Senator WIRTH. Are those your independent examination of the revenue forgone or tax losses and looking at the assets of the S&L's that had problems—is that OMB's assessment or are those numbers from the FSLIC?

Mr. DARMAN. On the revenue forgone question related to taxes, we are dependent—those are not our independent numbers. Those are numbers that are drawn from the Federal Home Loan Bank Board's reports to us on the tax treatment of the deals that were done and the interrelationship of that to the interest payments on the notes. On the rest of it, I believe we've done our own independent analysis and our numbers do not differ substantially from other numbers.

Senator WIRTH. You've done your own independent analysis of the assets of the bad S&L's that were taken over through 1988?

Mr. DARMAN. Only on a set of rule-of-thumb bases. In other words, we haven't gone into the institutions. Each of us in this business at the moment has a little bit different methodology—Treasury, the Fed, we, the Federal Home Loan Bank—but yes, we have our own methodology.

Senator WIRTH. The point of the question is that I think we're going to find that $40 billion probably is significantly higher, that we have heard from the bank board that their analysis of the revenue losses or taxes forgone is not systematic at all; and second, the examination of assets has not been done independently and they have found that to be very low as well. I just point that out for all of us.

REEXAMINATION OF ECONOMIC ASSUMPTIONS

The final point that I would like to make in the time that's available to me relates to your reexamination of the economic estimates. This administration really does not have at this point its own complete set of long-term economic estimates, that you're dependent upon what you were left with and the best job that you could do in a short period of time.

If that's correct, and I think that that's a prudent position for you all to take now, we're going to be going back and looking at long-term economic growth, looking at interest rates, looking at long-term inflation, and a set of questions.

Now it seems to me that it's prudent for us as a committee to have a sense of what that reexamination of economic assumptions are before we try to snap together an overall package here. That I think was part of what you and Senator Bryan were talking about.

At what point will we have that? When do you think that we will have that reexamination so that we can look upon a more agreed upon set of economic assumptions?

Mr. DARMAN. I don't think you will have it in time to act on this in a responsible way, because we're not going to have a formal reestimate until midsession, until July 15—a formal one. But I think that what we can do to help is provide the sensitivity analyses that we're asked for and show under different sets of assumptions what would it look like, and I think that then each can make his own judgment about where they think the economy is going to head and how much of an extra factor they think they need to protect against what might be a more pessimistic set of assumptions.

We have already built in, I might just note, an extra margin to deal with the fact that we could be wrong about interest rates and we could be wrong about the $40 billion estimate, as you suggested. That extra margin is on the order of $10 or $15 billion. There's a little difference between us and Treasury over how big the margin is. But we do have an extra margin in this plan as submitted.

So things would have to go pretty haywire in your set of assumptions—not you personally—you would have to make an assumption about a world pretty haywire to get out of range of what we've proposed.

Senator WIRTH. Even if you're wrong and too optimistic on interest rates, too optimistic on growth rates, you think there's still enough fudge factor in there or enough flexibility in your estimates to account for that?

Mr. DARMAN. I think so, provided, as I said in my statement and I've said a couple of times since, we also act responsibly on the larger fiscal problem so that we do get a pattern of interest rates coming down, even if not as sharply as we have projected.

The CHAIRMAN. Let me just say for the record that our understanding of the numbers—and I just doublechecked this with staff—indicate that the $40 billion for cases already handled does not include the projection of tax losses. In other words, the tax offsets that were really the driving aspect of some of the December deals I'm told are not calculated yet and are not part of the $40 billion. And I understood that we had been told that by OMB staff people. So, let's make sure we've got an answer we all agree on before we go forward.

Mr. DARMAN. Let me try one.

The CHAIRMAN. I don't want to delay. Senator Heinz has been waiting a long time. Is there a yes or no or does it take a long, elaborate answer?

Mr. DARMAN. It's pretty short $40 billion is the present value estimate of the cost of case resolutions to FSLIC. $52 billion on the outlay side would be the nominal value of these payments. The tax portion would be an additional amount that's included in the tax expenditures section of the budget nets the $40 billion in our analysis. But we can discuss it with you later if we've got some disagreement.

You wanted it short, Senator.

Senator WIRTH. At least $52 billion, Mr. Chairman.

The CHAIRMAN. That was a Michael Jordan move. You were at midcourt and the next thing I knew the ball was going through the basket and I'm trying to figure out if you walked on the way. [Laughter.]

This is where we need an instant replay. We'll come back to that.

Senator Heinz.

Senator HEINZ. Thank you. I feel I'd better get this ball off the floor pretty quickly here.

Mr. Darman, I think that we could probably spend an entire day talking about estimates and whether they're right or wrong, whether the assumptions are right or wrong, but I'll tell you what would be very helpful to the committee above all is to understand how seamless or leaky the administration bill is in the following sense.

If we enact the administration bill as is, and for reasons none of us foresee the cost to the Resolution Trust Corporation ends up being substantially larger than estimated, than the $50 billion, which includes the $10 billion fudge factor estimated, what happens? Is there a source of money that the Resolution Trust Corporation can go to if they need an extra $20 billion or, in effect, are they limited to the bonds plus the interest payments that we see in the plan?

Mr. DARMAN. If it were a cost to the RTC and it had already—I am just trying to understand the hypothesis—it had already exhausted all the resources, the $50 billion?

Senator HEINZ. The resources that the RTC has is the $50 billion.

Mr. DARMAN. It would have an additional $5 billion draw, but beyond that it would have to come back basically to the Congress.

Senator HEINZ. It could not go to the Fed?

Mr. DARMAN. No. It, itself, I don't think could go to the Fed.

Senator HEINZ. Can the RTC do what the FSLIC has done, which is to issue promissory notes, in resolving deals?

Mr. DARMAN. Yes, it could, and that is why I suggested that there ought to be some cap on the obligation authority for such obligations, that there needs to be some accountability in the system.

Senator HEINZ. I am strongly inclined to agree with you, but we will get an argument on that from some of the regulators, such as

Bill Seidman, who will say, look, I ought to have the flexibility I need to do deals.

Mr. DARMAN. Yes, I saw that, and I was disappointed to see that because I thought we had reached agreement on that point, he and I.

Senator HEINZ. Do you want to go back and try again?

Mr. DARMAN. Well, I think he must be assuming that he would be the regulator forever, and if he were, I would have complete confidence.

Senator HEINZ. I think you have established the basis for a deal. Now, go get it.

Let me ask you this—and if someone asked this while I was not paying attention, I apologize—would it be possible to use whatever model, computer model, the administration used—I don't know whether it was an OMB model or Treasury model, but somebody's model—to plug in different assumptions so we might have the benefit of sensitivity analysis as economic assumptions or other assumptions changed. Would it be possible for us or committee staff to get that?

Mr. DARMAN. Yes, Senator.

Could I make one request of the Chairman?

Since all these runs take a lot of man-hours because some of them involve judgments as well—it is not just asking a computer—could we get an agreed, manageable set of sensitivity runs we would like?

The CHAIRMAN. Yes, certainly. I think that is exactly the way to do it.

Senator HEINZ. I assume the Chairman would be the person who would be a very strict traffic cop and he might also be the judge and jury at the same time on that.

Mr. DARMAN. But that would be fine, Senator Heinz.

PUBLIC WILL BE ULTIMATE BENEFICIARIES

Senator HEINZ. One of the things that has occurred to some of us and that others also have suggested is that there are going to be, fortunately, some beneficiaries to this plan. The public will be the ultimate beneficiary because we will have reestablished the confidence in a thrift industry. But beyond the public, we will create out of the Resolution Trust Company some healthy thrifts. It won't be easy, but we will do it. We will also give the nontroubled part of the industry a new lease on what we hope will be a very happy and profitable life. Indeed, if it isn't a happy and profitable life, that is going to be a problem for some of the costs that we have estimated because those costs are very sensitive to deposit growth in those institutions.

At the same token, it would seem that, if things worked out well, there ought to be a way of having the public—you don't like the term "taxpayer"—the public that has underwritten the saving and the future of this industry to benefit in an equitable and nonpunitive way from the upside here.

Mr. DARMAN. Yes, that is through warrants.

Senator HEINZ. Just as was arranged with Chrysler Corp.

Mr. DARMAN. I think you must be implying that there ought to be warrants or something like warrants as part of the transaction.

Senator HEINZ. That is right. There is nothing explicit in the administration plan that deals with that.

Mr. DARMAN. No, that is correct, but warrants would still be quite possible if it were judged that in resolving a particular case there were a better deal for the public, for the public underwriter, to be gained through warrants.

Senator HEINZ. Those relate to troubled institutions, RTC-resolved institutions.

What about institutions that don't come to our door but still benefit from the new improved logos that they have on their door?

Mr. DARMAN. Well, I think what you are in effect suggesting is that—I mean, I don't know how you would manage it—you ask them to come up and offer warrants in existing healthy companies even though——

Senator HEINZ. I am not making a proposal. I am asking a question.

Mr. DARMAN. No. 1, I think it would be administratively awkward. Procedurally, I think there would be a lot of difficulties in determining what that kind of warrant arrangement should be from the healthy sector. In any case it would have to substitute for the premium increase if you assume that the premium increase is the maximum that they can bear because the warrant is also of economic value, and if they were giving that up, they would be raising the cost to themselves.

Anyhow, that type of warrant is not in our plan, and it is not like Chrysler because Chrysler was a single entity coming to negotiate. In this case I don't believe you could design it in a way——

Senator HEINZ. There are two ways of doing it.

One is to obtain warrants in a way that results in higher operating costs. I think that would be a very bad way to do it for the healthy industry. I think we have got a plan that is delicately balanced here.

The only way you could do it, if it is desirable to do, is to look at some kind of equity participation that is a sacrifice not of operating cost but of shareholder ownership, and that was the heart of the Chrysler deal notwithstanding the difference that it was one institution.

Let me just ask one related question if the chairman will let me and my colleagues will let me.

The CHAIRMAN. In this case the chairman will allow it.

Mr. DARMAN. Senator, in this case you would have to have a couple of thousand individually negotiated pricings of the value of warrants.

Senator HEINZ. I wasn't asking for an answer.

Mr. DARMAN. OK.

Senator HEINZ. I was just posing a concept.

May I ask one more question, Mr. Chairman?

The CHAIRMAN. I think so. Let me just say this now that we have had the interruption that Mr. Darman must leave before very long because he is due at a White House meeting. We have three members remaining that have not yet had a round of questioning, and I want to make sure that each one has a chance to do so.

Senator **Heinz**. I withdraw my request, Mr. Chairman.

The **Chairman**. You are very gracious.

Senator Gramm.

Senator **Gramm**. Mr. Chairman, I thank you. I thought our colleague was about to bail Chrysler out again, and I appreciate you stopping him. [Laughter.]

Senator **Heinz**. If my colleague will yield on my time, I didn't vote for that.

Senator **Gramm**. You have no time. [Laughter.]

Well, Mr. Chairman, let me thank you again for the hearing. Mr. Darman, thank you for being here.

I would like to make a couple of points. One of the problems of coming late is all the good questions get asked, but I am glad I stayed because there are a couple of points I want to make and I want to try to be as emphatic about them as I can.

I think, first of all, the best and real reason that the Treasury should not borrow the money is because the Treasury is not borrowing the money. The thrift industry is borrowing the money, and we expect them to pay it back, and that is about as fundamental a reason for the Treasury not borrowing the money as you can have a reason for the Treasury not borrowing the money.

Now, I guess I would have to say—and I don't mean to offend anybody, but I want to be sure that at least for one member it is clear where I am coming from—first of all, if anybody held a contingency liability on FSLIC, it was the thrift industry. It is a rotten, stinking deal that we have got a big loss sitting out there, but God knows if anybody had a contingency liability it was not the taxpayer, it was the thrift industry, and in any kind of legal sense we had the right to come in and seize every asset of every savings and loan in America.

Instead, we have worked out or you have worked out in the Treasury a very balanced and I think fair plan. I don't think anybody in the thrift industry can argue that they are being cheated by this plan.

But I think the quickest way this plan could be killed would be if the thrift industry came in and said, well, wouldn't it be a great idea, in addition to paying the interest cost, in addition to picking up the tab and absorbing all the liability for what we may lose on all these assets that we are going to take over as we pay off depositors, wouldn't it be a great idea if the Treasury simply borrowed the money so that the thrift industry did not have to do that?

I want to assure you that I am not going to support that, and this deal is going to come apart very, very quickly if we start moving in that direction, from my point of view.

I think it is imperative that the thrift industry borrow this money. It is one thing to ask us to subsidize the payment of the interest. It is another thing to have us borrow the money, and so my view is that it is very clear the Treasury is not borrowing the money because this is not Treasury borrowing the money.

I mean, in essence we could save money in all our farm credit programs by having the Treasury borrow the money instead of the Farm Credit Program, but it is the Farm Credit Program that is borrowing the money.

That is the end of that sermon.

A CAP ON THE PUBLIC'S EXPOSURE

As a second point—and I want to turn this one into sort of a question—it seems to me that if we wanted to put a cap on the taxpayers' exposure here or the citizens' exposure, one way we could do it would be to write a cap into the bill, and then to the extent that that cap was breached to slow down the rate at which the capital buildup was required in the bill and raise the fees to cover that.

Would you see that as feasible?

In other words, in this bill, the way it is written——

Mr. **Darman**. What would happen after the cap is hit?

Senator **Gramm**. Well, let's say that the cap were hit and that we were part way in raising the capital of the remaining thrifts from 1.9 percent to 6 percent. What you would do under that circumstance is you would raise the fee, you would lower the required capital requirement, and in essence you would force the industry into a self-help program to pick up the amount that is paid above the cap.

Mr. **Darman**. Senator, I would not favor that for a couple of reasons. Obviously, this is off the top of my head because I just heard the proposal.

But it seems to me that what you would be doing in that circumstance—first of all, if you are in that circumstance, it would have to be very quickly, so something must have gone radically wrong if you have figured out how to blow $50 billion before mid-1991 and you are in this situation.

Senator **Gramm**. Well, we have done it pretty quickly already.

Mr. **Darman**. If we were really in that situation, I suspect we would have a very much larger problem to deal with than just the S&L industry. I can't imagine the exact circumstance that would result in this, but suppose it did, treating it as, I think, an extreme hypothetical.

Then what you would be doing, though, is saying in a situation where the industry is not as healthy as you hoped it would be you are going to charge a higher fee to them, which is going to increase their cost when presumably you don't want to because they are in trouble. In addition, you are going to give them the relaxation of a lower capital requirement, but that removes just the protection you are trying to provide in terms of a cushion where they have got some capital that is ahead in line, that is at risk, before you get to the public.

Senator **Gramm**. Yes, I know. Every smoker who gets lung cancer and whose earning power is impaired and who has medical bills makes the same argument.

Mr. **Darman**. Well, in any case, Senator, I really think you would be very hard pressed to define a scenario in which what you just described—may I suggest an alternative way to look at it?

I do think, as I said before, there are a couple of caps in this proposed bill, and I would urge the committee to continue, notwithstanding Bill Seidman's testimony to the contrary, at least to look at keeping those caps because they do force us to revisit the issue in the unlikely event that you were to exceed those limits. My own opinion is in the circumstance in which you are likely to exceed these caps something will have gone wrong enough so that we really ought to have some rather serious review. It ought to come back to the legislative process.

Senator GRAMM. Well, let me say, Mr. Chairman——

The CHAIRMAN. Senator, excuse me. I hate to interrupt, and I have not done this yet at any time, but we made a commitment to the Director that he would be able to get back to the White House meeting, and you have got three colleagues that have waited and want to ask, and I almost think that we ought to try to accommodate them if we can.

If that is agreeable, I think we should go to Senator Roth.

Senator GRAMM. That is fine.

Senator ROTH. Thank you, Mr. Chairman. I will be brief because of the lateness of the hour, but I would like to ask you, Mr. Darman, is it appropriate to include interest costs as part of the cost of the plan? Do we do that in other programs? Should we, particularly when we are running a deficit?

Mr. DARMAN. Well, I try not to get into this debate, Senator. I think it is certainly appropriate to analyze the interest costs associated with this, and the debate tends to turn on the question, well, do we say that is—is that the right way to look at the cost or the problem?

For most of what the rest of the Government does, we don't do that, and if we were going to be consistent, it might be appropriate to do it for all of the rest of what the Government does. Our own credit reform proposals, the administration's own credit reform proposals, begin to get at that in terms of reflecting some of the hidden costs, but they still don't fully account for the financing of what government is doing.

It isn't the way we legislate. I think you can argue that it would be a more sensible way to do things. It is not the way we are now doing things.

Senator ROTH. What kind of impact will the higher premiums imposed on S&L's have on their capability of raising the level of capital quickly?

Mr. DARMAN. Well, first of all, the higher premiums don't come into effect for the S&L's immediately, and I think that it is more than offset, more than offset, by the fact that their competitors—the bank premiums are rising to a level that is closer to the S&L's so that the competitive disadvantage they are at is shrinking under the proposed plan. That is a plus for S&L's.

But even more important for S&L's, and to a degree also for banks, the cost of money should be declining as we move quickly to clean this up because you are taking out of the system some of the parties who are furiously competing to get deposits and driving up the cost of money. They are competing to get cash in the hope that they will survive, if they are honest, and in the process helping drive down the ones that are healthy.

So from the standpoint of the viable S&L's, they will benefit much more than they would lose from a higher premium from the favorable competitive effect vis-a-vis banks and from the removal from the current market of people who are bidding rates up artificially high.

Senator ROTH. I have no further questions.

The **Chairman**. Thank you very much.

Senator Pressler.

Senator **Pressler**. Thank you very much.

I know this has been covered some, but I just would like to ask one brief question, and that is based on a Wall Street Journal article entitled "Bush S&L Bailout Creates Illusion of Deficit Cut That Congress Questions But Wants To Believe," and this article—I think you probably are familiar with it.

You are not?

It calls you the smartest person alive. So you should read it. [Laughter.]

Mr. **Darman**. If I were you, Senator, I wouldn't trust that source. [Laughter.]

Senator **Pressler**. But in any event, it says:

> Government spending on insolvent savings and loan will actually increase substantially in the year beginning October 1, but with some accounting sleight of hand, that huge liability has been turned into a sizable asset, easing the administration's budgetary squeeze.

I think you know the issue there. In explaining this, is this a wise thing and is this basically true?

Mr. **Darman**. I haven't read the article. I don't quite know what it is.

Is this referring to the fact that we have a favorable outlay effect in 1990 relative to 1989 and then it moves up a little in 1991?

Senator **Pressler**. Yes, that is correct. It refers to the reduction in budget outlays for the savings and loan rescue piece stems.

Mr. **Darman**. Yes.

Senator **Pressler**. I think you understand it.

Mr. **Darman**. I think, if I understand it correctly, that I can explain why that is the case. The reason is that we start financing the solution with what Senator Gramm referred to as private borrowing, and he is correct with respect to the principal. It is fully covered on the private side.

What is happening is in the world we are living in at the moment, where this problem is not being adequately addressed and resolved, we don't have the resources necessary to cover the resolutions. So as we know, for example, in December and just prior to that, there was a substantial amount of paper written, which gets scored legitimately, immediately, as a deficit outlay effect. Adverse. The deficit goes up.

So the 1989 number, because of the resolutions taking place that way, is abnormally high. As soon as we start financing this as we go, which is what this system does, you don't have to do that any more. You have got a different financing scheme. You don't have that big hit on outlays.

So I think the narrower question that somebody should ask is related to the pattern of funding in terms of when you get the new flows in from the private bonds, from the REFCO bonds, and that pattern is $10 billion, I think, for 1989, $25 billion for 1990, and $15 billion for 1991. It is that blip of having $25 billion in 1990 that somebody might ask about and say, well, how did you happen to get $25 billion in 1990 and you got $10 billion in 1989 and you only got $15 billion in 1991.

That is at least the way I would ask the question, and here is what the answer would be.

If you have defined the overall need as $50 billion and you want to do it as quickly as is reasonable and feasible, you have to ask, well, what is the fastest we can get moving in 1989, calculate how many resolutions can be done with the staff and the resources available, and so on. When you estimate that—when we did, we came up with the answer, though we would like to do more in 1989, just the practical limitations, getting the legislation through, pulling the staffs, the organization together, getting all these resolutions done, it can only use up about 10 billion dollars' worth of resolution money.

The next year, when you are further along, you would like to do all of the remainder if you could. It is not to say you would unload all the assets in that year, but you would like to do all of the resolutions if you could in that year, except you are limited in that year by, again, resource availability, people to negotiate the deals, how fast you can do these deals, and so on. You are also limited—and this would be true to some extent whether you were doing it with Treasury financing or private financing—you are limited by how much you want to float in the market in bonds, and the estimate made by outside investment bankers and Treasury on this was that a $25 billion issue was about the maximum you could do without beginning to adversely affect the price. And so that number was arrived at, with people saying we want to do the maximum we can but what can the market bear, the market can bear about $20–25 billion. That is where that number came from.

And the third year number is the remainder, and the numbers just work out the way they do after you do that.

Senator PRESSLER. OK, but the basic question is it seems to me that the money borrowed by the new corporation will simply be handed over to the Government and will appear on the books as a receipt. Thus, it will actually reduce——

Mr. DARMAN. No.

Senator PRESSLER. That is not correct?

Mr. DARMAN. Well, it goes out the door the minute it goes in. It is an instantaneous transaction that exists on paper only and conceptually only. The money is transferred from a private source for the purpose of resolution, and it is only when the money is needed for resolution that the money is transferred.

So if you have a $10 billion need for resolution, there is a $10 billion transfer from the private entity. It is scored, you are correct, as a receipt, but there is immediately an offsetting disbursement. They are dollar for dollar offsetting.

Senator PRESSLER. OK, well, then the Wall Street Journal article is perhaps wrong. I will give this to you, and perhaps you could respond in a writing.

Mr. DARMAN. Yes.

Senator PRESSLER. Could I just ask one more thing?

Now, as I understand it, an organization can be taken off budget if it is privately owned, and in this case two-thirds or more of the interest payments on the bonds would be paid by Treasury, which makes it difficult to argue that the corporation is not part of the Government.

Mr. DARMAN. Well, sir, I would look at it this way, and I think this is the point that Senator Gramm was trying to make. In fact, I really don't see why there is a question on this, I am sorry to say.

THE FEDERAL GOVERNMENT HAS NO OBLIGATION TO COVER THE PRINCIPAL

In common sense terms, there is borrowing of an amount in principal and interest. Who is obligated to cover the principal? The Federal Government has zero obligation, none, not one dime, not a penny of obligation to cover the principal. It is already fully covered under this proposal, the whole $50 billion, by the private purchase of zeroes. So the only public exposure is, as you have suggested, for the interest, and that amount should be on budget and it is on budget.

But it comes close to defying comprehension why—if the private obligation to cover the principal is already fully defeased with the purchase of zeroes, why in the world one would want to count that as an on budget obligation of the Government. The Government has zero obligation, none, for the principal. It does have an obligation for the interest.

We are saying for every single dollar of obligation it has for the interest that we estimate, absolutely, that should be on budget, absolutely no question about it, and if the interest estimate is off—and a number of questions have asked us to do a sensitivity analyses, and we are happy to do that—then the outlays, the Federal obligation, will increase by the amount that the estimate is off, if it is unfavorable, for the interest.

But there is none, zero, 0, Federal obligation for the principal, and it is fully defeased in advance by the private purchase of the zeroes. So I can't see why that $50 billion should be assumed to be a Federal obligation when it isn't.

Senator PRESSLER. So to boil that down, I can safely tell my constituents that we are not adding to the deficit of the United States?

Mr. DARMAN. We are, to the tune of—or at least we are adding to outlays that need to be covered one way or another to the tune of $39.9 billion, we estimate, over 10 years. But under this proposal, let's put it this way, you could tell your constituents that of that $50 billion the obligation to repay the principal is totally already—under this proposal, if it is enacted—paid for by private parties, the parties who are there to benefit, not by the taxpayer. The Federal Government has no obligation to pick up that $50 billion.

The Federal Government does have an obligation to be the backup on the interest.

Senator PRESSLER. But the Federal Government would be the backup if something went wrong?

Mr. DARMAN. But nothing can go wrong unless the whole Government collapses, and its viability with respect to the principal, because the principal is covered by zero coupon bonds that are Treasury bonds. If we are assuming that there will be a day in which those bonds are worthless, we are talking about a very much worse problem than the savings and loan crisis.

Senator PRESSLER. OK, Mr. Chairman, I can see that I am infringing on my colleague's time.

I ask unanimous consent that this Wall Street Journal article, entitled "Bush S&L Bailout Creates Illusion of Deficit Cut That Congress Wants To Believe," and I would very much appreciate your analysis of this.

Mr. **Darman**. Yes, sir, I will be happy to.

Senator **Pressler**. I would be happy to provide you with it.

The **Chairman**. Without objection, it is so ordered.

[The article from the Wall Street Journal and response follows:]

Wall Street Journal
FEb. 21, 1989
Page A-18

Bush S&L Bailout Creates Illusion of Deficit Cut That Congress Questions but Wants to Believe

By ALAN MURRAY
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON – The savings-and-loan crisis looks like a bonanza when viewed through the strange prism of President Bush's fiscal 1990 budget.

It shows government spending on deposit insurance *declining* by $14 billion from the current year. That's enough to pay for the president's new spending initiatives three times over.

The $14 billion windfall, of course, is a mirage. Government spending on insolvent savings and loans will actually increase substantially in the year beginning Oct. 1. But, with some accounting sleight of hand, that huge liability has been turned into a sizable asset, easing the administration's budgetary squeeze.

"I'm amazed, amused and bemused," says Carol Cox, director of the bipartisan Citizens for a Responsible Federal Budget. "Would you believe the thrift crisis is going to save us money and reduce the deficit? Well that's just what the budget says!"

The deposit-insurance artifice, involving off-budget financing, is the biggest in a bag full of tricks that Budget Director Richard Darman used this year to pull off a remarkable budgetary coup. His proposal included a far sparser rise in overall government spending than any Reagan budget. But it is skillfully packaged to emphasize spending increases and obscure painful spending cuts.

As a result, it's the first budget in eight years to escape the fate of being declared "dead on arrival" by Congress. Concludes Ms. Cox: "Dick Darman is the smartest person I've ever observed."

Fiscal 1990 Federal Outlays Projected for S&L Bail-Outs

Total S&L spending	$31.2 billion
Off-budget borrowings	-25.0 billion
Other offsets	- 4.3 billion
On-budget spending	$1.9 billion

Source: Office of Management and Budget

The reduction in budget outlays for the savings-and-loan rescue stems from the administration's plan to create a new company, called the Resolution Financing Corp., which will borrow $50 billion over the next three years by selling long-term bonds. The company will be modeled after other government-sponsored but privately owned enterprises, such as the Federal National Mortgage Association (Fannie Mae). And like Fannie Mae, the new corporation won't be part of the federal budget.

The money borrowed by the new corporation, however, will simply be handed over to the government, and will appear on the federal books as a "receipt." Thus, rather than increasing the budget deficit, the scheme actually *reduces* it.

Defenders of this artifice argue that the bond sale should be off-budget because it doesn't have the same economic effects as most types of deficit spending. While borrowing to finance government spending drains the nation's pool of available capital, borrowing to rescue thrifts doesn't. Instead, it merely transfers capital from bond buyers to thrift depositors.

Budget experts say the new borrowing ought to be counted in the budget. "It gets to be a murky legal issue," says Rudolph Penner, former director of the Congressional Budget Office. "But conceptually, forgetting the intricacies of accounting, I really do think it should be counted as federal borrowing."

Moreover, by creating a new borrowing agency, the government will be forced to pay a higher interest rate than it would on straight government debt, increasing the taxpayers' cost by anywhere from $2 billion to $8 billion over the life of the bonds.

"This is not just an arcane, inside-the-beltway bookkeeping dispute," says GOP Rep. Willis Gradison of Ohio. "The Treasury plan is a highly creative accounting shell game which gives a windfall to the purchasers of $50 billion of new debt in order to be able to argue that the FSLIC rescue should be off-budget. That's a mighty high price to pay for appearances."

Budget accounting rules, established by a federal commission in 1967, allow an organization to be taken off the budget if it is privately owned. Administration officials argue that the Resolution Financing Corp. passes that test. They say it isn't any different than the Financing Corp. set up two years ago to raise money for recapitalizing the Federal Savings and Loan Insurance Corp. Both the Office of Management and Budget and the Congressional Budget Office agreed that that corporation could be treated as an off-budget entity.

But Financing Corp., or FICO, bonds were financed totally by money from the S&L industry. In the case of the new corporation, two-thirds or more of the interest payments on the bonds would be paid by Treasury, making it difficult to argue that the corporation isn't part of the government.

Thomas Stanton, a Washington lawyer who specializes in government-sponsored enterprises, says the new corporation "clearly and unambiguously fails the private-ownership test." And the Congressional Budget Office sent a memo to the House Ways and Means Committee last week that said putting the new corporation off-budget may damage "the integrity of the unified budget, the meaning of the budget deficit, and deficit-reduction efforts."

Mr. Darman, however, doesn't share that view. "Some people will make the argument, including perhaps some in the Congressional Budget Office, that the payment of interest by Treasury changes the budgetary treatment," says a spokesman for the White House budget office. "We do not accept that argument."

And despite the Congressional Budget Office's complaint, Congress is likely to accept the administration's legerdemain. That's because, like the White House, members are anxious to meet the Gramm-Rudman law's deficit-reduction targets this year, without facing the political pain of excessive spending cuts or tax increases.

Rep. Gradison has proposed, as an alternative, putting the borrowing for the S&L bailout on budget, but exempting it from the Gramm-Rudman targets. Other members of Congress, however, don't want to vote for an exemption to the budget law. Administration officials fear an explicit exemption from the deficit-reduction targets would open the door for Congress to exclude other spending programs.

As a result, the unusual financing scheme seems likely to become law. "In the end," says Mr. Gradison, "it's easier to go along."

FSLIC and FDIC Outlays in Bush Budget

- The Bush Administration plan for resolving the thrift crisis does reduce total 1990 budget outlays for the FSLIC and the FDIC below both 1989 outlays and the 1990 outlay estimates for FSLIC and FDIC in the final Reagan budget.

- This reduction occurs even though FSLIC total 1990 spending of $31.2 billion to resolve insolvent thrifts is $3.5 billion higher than total 1989 spending and $22.1 billion above the estimated total FSLIC spending in the 1990 Reagan budget.

- The principal reason for this is that the Bush budget obtains additional non-governmental funds to finance or offset higher FSLIC spending in 1989 and 1990 primarily from two sources: a) REFCORP payments, and b) higher bank insurance premiums.

  - The Resolution Funding Corporation (REFCORP) is a newly created, off-budget subsidiary of the privately owned Federal Home Loan Banks that will provide FSLIC $10 billion in 1989, $25 billion in 1990, and $15 billion in 1991 (a total of $50 billion). These non-governmental REFCORP funds will finance all the FSLIC spending to close or merge remaining insolvent thrifts in those years. These REFCORP funds fully offset the increased FSLIC spending in those years and thus eliminate the budget outlay that spending would have caused.

  - higher proposed insurance premiums on commercial banks starting in 1990 increase 1990 budget receipts by roughly $.8 billion; these additional receipts offset higher FSLIC spending even though they are not used to finance that spending directly.

- Total FSLIC and FDIC budget outlays were projected to decrease $11.7 billion from 1989 to 1990 under the Reagan budget estimates:

  - FSLIC budget outlays in the Reagan budget declined $6.6 billion from 1989 to 1990, because the excessive use of FSLIC notes to finance additional spending had adverse budget and program cost effects, and,

  - FDIC budget outlays decreased $5.1 billion between 1989 and 1990, because FDIC estimated that its large commercial bank failures would have been resolved by the end of 1989.

The CHAIRMAN. Senator Kassebaum.

Senator KASSEBAUM. Mr. Chairman, I think Mr. Darman's last comment was a good way to end the hearing. I assume most of the important questions have been asked. I only regret I wasn't here to hear the full commentary of Mr. Darman, who I greatly admire.

Thank you.

The CHAIRMAN. Thank you. I will just make two comments before excusing you as a witness.

Mr. DARMAN. Thank you, Senator.

The CHAIRMAN. We will put together a small working group on the committee to work with you and your people on constructing how we would like to put a sensitivity analysis together on some of these critical economic assumptions. Let me state further it would be my hope and my intention that in doing so, we would do so in a cooperative manner so that if we end up judging that we need to adjust the amount of money that is going to be provided based on a judgment about what might be the best set of assumptions, the most prudent set of assumptions, that we could talk that through quite thoroughly as we went along.

Mr. DARMAN. Absolutely, Senator. I think that is the right way to proceed.

The CHAIRMAN. Finally, I want to say one other thing, and that is that we are ending now. A number of colleagues wanted to go through a second round. They left because they knew of the time pressure.

I don't know that we will need to have you come back at some point. I know you presumably would be available to do so, but if we find that in locking this thing down we need to have you back another time, I assume you would be prepared to come.

Mr. DARMAN. Yes, sir, I would always be prepared to come, but on the other hand, if by chance we could do it without my coming back, I would sure be appreciative.

The CHAIRMAN. Yes, that would be our preference as well.

Thank you very much.

The committee stands in recess until 10 o'clock tomorrow morning.

[Whereupon, at 12:10 p.m., the committee was recessed, to reconvene at 10 a.m., Friday, March 3, 1989.]

[Reponse to written questions to witnesses follow:]

QUESTIONS FOR SECRETARY BRADY
FROM
SENATOR DONALD W. RIEGLE, JR.
HEARING OF FEBRUARY 22, 1989

Q.1. In discussing the current structure of thrift regulation, you state that "the goals of the regulator as an industry advocate and insurer are inherently in conflict."

(a) Isn't there also an inherent conflict between acting as an industry advocate and regulating effectively in the public interest?

(b) Given the multi-billion-dollar price tag for past failures of thrift regulation, is it really desirable for a regulatory agency such as the proposed Federal Home Loan Bank System to act as an advocate for the industry it is supposed to regulate?

Answer

We have addressed this important issue by proposing in the Administration's legislation that the Chairman of the Federal Home Loan Bank System's mandate regarding the promotion of housing be modified to read "consistent with the safe and sound operation of Federal savings associations (Sec. 305)". Effective Treasury oversight can also ensure a strong and safe system of housing finance.

The savings and loan industry was established to promote housing. It seems appropriate for the industry's regulator and charterer to have this imprimatur, so long as it is pursued with a concern for the safety and soundness of member institutions. If savings and loan associations had faithfully pursued their responsibilities for residential housing in recent years, we might not have had such serious problems in the industry.

Q.2. Concern has been expressed (a) that stronger capital standards could cause many marginally healthy thrift institutions to fail, and (b) that these additional failures would increase the cost of dealing with FSLIC's problems. What is your response?

Answer:

(a) Minimum capital requirements do not "cause" institutions to fail. In fact, adequate capital requirements are regulatory tools that prevent failures by ensuring prudent business practices. The 2,455 solvent S&Ls with $1.07 trillion in assets currently have $55 billion in capital, and would only need $64 billion ($9 billion more) to meet the 6 percent capital standard. About 50 percent of these institutions have capital-to-asset ratios of at least 6 percent. Using risk-based capital accounting, OMB has estimated that over 70 percent of these institutions would meet the higher standard.

As they have done in the past, thrift management can achieve higher capital levels in many ways, such as: (1) retain profits instead of paying them out as dividends; (2) issue more common stock or a certain amount of preferred stock and subordinated debt; (3) shrink assets; and (4) merge with another institution.

Of the solvent S&Ls, 87 percent with 80 percent of the assets have at least 3 percent GAAP capital. Many of these institutions in the 3-6 percent capital range undoubtedly chose to maintain capital at the lowest possible level and still remain in good regulatory standing. The overwhelming majority of these savings and loans should be able to meet the 6 percent requirement by 1991.

In addition, passage of the President's plan should improve the climate for healthy thrifts to attract new capital.

(b) The Administration's proposal has additional funds, beyond what would be necessary to resolve currently insolvent institutions, already built into it. Our plan provides significantly more funds than we believe would be required to resolve all 350 GAAP insolvent institutions, plus the 150 marginally solvent institutions that may become insolvent and require resolution by the Resolution Trust Corporation (RTC). Our plan also provides an average of over $3.0 billion a year from 1992 to 1999 for future case resolutions, should they become necessary.

Q.3. Concern has been expressed that if a thrift institution were unable to meet applicable capital standards by June 1, 1991, the Administration's proposal would require that the institution be sold or liquidated.

(a) Is that true?

(b) What consequences would a solvent institution face if it were unable to meet applicable capital standards?

Answer:

For those institutions that do not meet the 6 percent standard in 1991, the capital threshold is not a "make it or liquidate" standard. If a thrift has a realistic business plan and demonstrates substantial progress toward the capital standard, the appropriate federal regulator can use its supervisory capacity to extend the time period in which that thrift can achieve the capital objective, although the institution would not be permitted to grow further to do so. Moreover, it is highly unlikely that a regulator would liquidate any thrift with substantial capital since merger is the cheaper alternative.

Q.4. You have proposed to give the FDIC limited authority over capital and accounting standards for federally insured thrift institutions. If Congress were to strengthen that authority in the interest of protecting the deposit insurance fund would you object?

Answer:

We certainly favor the FDIC having adequate authority over capital and accounting standards for federally insured thrift institutions. We believe we have arrived at an appropriate balance in the President's proposal for both capital and accounting standards. We do not want the FDIC or any regulatory agency to have authority that is so excessive it impedes proper public policy and market competition.

Q.5. Under the Administration's proposal, the Chairman of the FDIC would be designated by the President from among the appointive members of the FDIC's Board of Directors. Why does the Administration propose to change the current system, under which the Chairman is elected by the members of the board? What evidence is there that the current system is defective?

Answer

The Administration believes that a President should have the authority to appoint the chairman of every regulatory agency early in his administration. It happens at the moment that we are addressing legislation to restructure the FDIC, hence, it is timely to introduce this concept to the management of this agency. Appointment of a new FDIC chairman and vice chairman early in a new administration will help the President deal with any problems he may need to address regarding that agency. The President needs the ability to assert accountability to the public for regulatory activities at the outset of his administration. This approach is consistent with other appointments at other independent regulatory agencies.

Q.6. Under the Administration's proposal, the FDIC's Board of Directors will be expanded from three members to five, and the Comptroller of the Currency and the Chairman of the Federal Home Loan Bank System will be members ex officio. On February 12, 1989, the New York Times reported that the Federal Reserve Board had sought to have its Vice Chairman included on the FDIC board, but that its request had been rejected.

(a) Did the Federal Reserve Board seek representation on the FDIC Board?

(b) If so, why was its request rebuffed? Why does the Administration believe that the FDIC's Board of Directors should include representatives of the OCC and the FHLBS but not of the Federal Reserve?

Answer:

(a) During the process of formulating this legislation we consulted with many government departments and agencies, members of Congress, and many private organizations and citizens. It does not seem appropriate for us to comment on these internal discussions in the current debate.

(b) The Administration has no position on the question of Federal Reserve membership on the FDIC Board.

Q.7. Concern has been expressed that the FDIC's authority to increase insurance premiums to 35 cents per $100 of insured deposits would discourage investment in banks and thrift institutions.

(a) what is your response?

(b) Is that authority really needed? If so, why?

(c) why did you set the upper limit at 35 cents per $100, rather than some lower or higher figure?

Answer:

Section 208 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRRE Act) states that the FDIC may raise the rates for the Bank Insurance Fund (BIF) or the Savings Association Insurance Fund (SAIF), if the FDIC makes any of the following findings about either fund: (1) that the fund has experienced a net loss in any of the prior three years; (2) that the fund's "reserve ratio"--the ratio of its net worth to insured liabilities--is less than 1.20 percent; or that extraordinary circumstances exist that raise a reasonable risk of serious future losses to the fund in question. The FDIC may not raise the rates more than 50 percent over the prior year's rate.

We believe this authority to increase premiums is necessary because the FDIC's primary mandate is to preserve the safety and soundness of the insurance fund. As such, the insurer needs to be insulated from industry and other pressures which may argue against raising premiums, although the increases may in fact be needed to protect depositors.

With regard to your question about investment in banks and thrifts, the health and profitability of the banking industry is best insured by a sound insurance fund. As we have seen during the past few months, lack of public confidence in the soundness of the thrift industry has increased as the problems of the FSLIC have become well publicized.

Q.8. When Senator Heinz asked which state-authorized activities should be impermissible for federally insured thrift institutions,you replied:

> "I don't have a precise litany of powers that would be restricted, but we have seen all kinds of outlandish investments -- herds of prize cattle, dirt loans, so-called, investing in open fields, all that kind of thing that I think should be throttled back."

Please state specifically which State-authorized activities you believe should be impermissible for federally insured thrift institutions.

Answer:

The President's plan leaves to the discretion of the FDIC the determination of which activities pose a threat to the insurance fund. Specifically, Section 218 states that the FDIC may determine by regulation, with respect to all State-chartered SAIF members (after consultation with the Chairman of the FHLBS and after allowing comment by appropriate State supervisors) that any specific activity (other than any activity permitted to a federal savings and loan association) poses a serious threat to the SAIF, and may prohibit any such activity. Once the FDIC issues such a regulation, it may order that no SAIF member may engage directly in that activity.

We believe strongly that the FDIC, as insurer, is best positioned to make these kinds of determinations in a rapidly evolving financial marketplace.

Q.9. Under the Administration's proposal, the FDIC would have certain authority to prohibit or restrict the exercise of State-authorized powers by federally insured thrift institutions. Would that authority really be any broader than the authority currently possessed by FSLIC? If so, in what way?

Answer:

The FIRRE Act would give the FDIC the power to deny insurance to any savings institution on financial grounds or on the basis of the risk presented to the fund. The FSLIC currently does not have such authority. Section 205 provides that the FDIC Board (which may not delegate denial authority) may, after reviewing the application for insurance, decline to insure the applicant. The FDIC Board must provide specific written reasons to the Chairman of the FHLBS for any such denial.

The difference between the FHLBB's current authority over State-chartered institutions and those proposed for the FDIC under the Administration plan is that the FDIC's authority to restrict activities of State-chartered institutions would be expressly written into statute. Currently, the Home Owners' Loan Act and the National Housing Act allow the FHLBB broad oversight authority over State-chartered activities, although this authority is not expressly stated in the statutes.

Q.10. What, if any, additional regulatory authority is needed to prevent the abuse of brokered deposits?

Answer:

We believe the controls over brokered deposits contained in Title 3 of the FIRRE Act will prevent misuse of those deposits by savings and loans. Section 314 states that the Chairman of the FDIC may restrict the asset growth of any savings association that the Chairman determines is taking excessive risks or is paying excessive rates for deposits. These growth limitations are intended to prevent troubled thrifts from increasing their size through brokered deposits.

Q.11. You state that under the Administration's proposal, "bank holding companies will be permitted to acquire a failed or failing savings and loan without the existing cross-marketing and tandem restrictions. After two years bank holding companies will be able to acquire any savings and loan without these restrictions." If a bank holding company acquired a thrift institution more than two years after the enactment of the Administration's proposal, would the bank holding company be free to engage through the thrift institution (or its subsidiaries) in any activities in which the thrift institution (or its subsidiaries) was otherwise authorized to engage? For example, thrift institution in underwriting and selling insurance, underwriting and dealing in corporate securities, and developing real estate, all without regard to the restrictions that would otherwise apply under the Bank Holding Company Act?

Answer:

> Under the Administration's proposal, when a bank holding company acquires a thrift institution or thrift holding company, the combined organization may continue to conduct only those activities authorized for both bank holding companies and saving and loan holding companies as under current law. Other activities performed by nonbank subsidiaries of the holding company that do not conform to those authorized by both the Bank Holding Company Act and the Savings and Loan Holding Company Act must be discontinued.

Q.12. What steps has the Administration taken to ascertain the true future costs -- both to FSLIC and to the Government as a whole -- of FSLIC-assisted transactions that were entered into during 1988? Are you confident that you know what those costs will be? Will you promptly notify the Committee if your current estimates change?

Answer:

> Under section 501 of the FIRRE Act, the Resolution Trust Corporation will have the authority to analyze any FSLIC resolutions completed since January 1, 1988 and report its conclusions to the Secretary of the Treasury. The RTC would actively review all means by which it can reduce the cost of existing FSLIC assistance agreements, including the restructuring of past agreements, subject only to the monitoring by the Oversight Board. The RTC with the express concurrence of the Oversight Board would restructure agreements where savings would be realized.

The RTC would report to Congress any restructuring of past agreements. The Treasury has not yet independently computed the estimated cost of FSLIC's past resolutions.

Q.13. Will the zero-coupon Treasury bonds that are to serve as collateral for securities issued by the Resolution Trust Corporation be obtained in the secondary market or directly from the Treasury?

Answer:

Treasury has not made a decision about whether or not to issue zero-coupon bonds directly to REFCORP for debt defeasance purposes. Treasury will consider the financing of REFCORP in the overall context of financing the government's needs to prevent disruptions to the securities markets and minimize the Government's cost of financing.

Q.14. In support of the Administration's proposed changes in the NCUSIF, you state that "as long as credit unions consider their contributions as assets, they will resist the using of these assets to cover insurance losses."

(a) What, if any, evidence is there that credit unions have resisted the NCUSIF's using its reserves to deal with troubled credit unions?

(b) Is there any other evidence that the current system is in need of reform? Why do you believe the Administration's proposed changes in the NCUSIF would be an improvement over the current system?

(c) Doesn't the current pay-as-you-go structure of the NCUSIF give credit unions a strong incentive to support effective supervision and regulation, as credit unions know that they will have to recapitalize the NCUSIF promptly if it incurs substantial losses?

Answer:

In the four years since the NCUSIF was restructured, the fund has not experienced losses large enough to threaten the one percent of total shares that its members have on deposit. In fact, the income from investments in the fund has been more than enough to cover losses. However, our concern is with the possibility of significant, unforeseen insurance losses some time in the future, not unlike what both savings and loans and banks have recently experienced.

Although credit union deposits have been growing at annual rates sometimes well in excess of 15 percent, about 30 percent of all credit unions have capital levels under 5 percent. This suggests that they may be out-growing their capital.

In a time of crisis for the Fund, credit unions would have to write down their investment in the Fund and simultaneously bring it back up to one percent. The result could be a severe contraction in the industry's capital at a time when it could least afford it. Such a write-down among healthy credit unions could cause additional failures, thus creating a downward spiral. The insurance funds for both Ohio and Maryland savings and loan associations were structured like the NCUSIF when their problems occurred; we would prefer to learn from history's lessons.

An unfortunate precedent was set by the decision of Congress in the Competitive Equality Banking Act of 1987 to repay the FSLIC's secondary reserves of $825 million to those thrift institutions that carried the secondary reserves as assets on their books. In the event of significant insurance losses in the credit union industry, such a precedent would surely be invoked.

Q.15. Under the plan announced by the Administration on February 6, the Comptroller General was to be a member of the Resolution Trust Corporation's Oversight Board. But in the Administration's current proposal, the Comptroller General has been replaced by the Attorney General. Why was that change made?

Answer:

There was some concern that placing the Comptroller General on the Oversight Board might result in a conflict of interest arising from the General Accounting Office's responsibility to audit the Resolution Trust Corporation. Moreover, in light of the Supreme Court decision, Bowsher vs. Synar, there was concern about the constitutionality of the board proposed in the outline.

Q.16. The Administration's proposal would authorize $50 million per year for three years for the Justice Department to fund a new national program to search out financial institution fraud. This program, you state, "will include new investigators, auditors, analysts, and prosecutors trained in specialized and sophisticated methods of financial institution fraud."

(a) Is a three-year program really sufficient to get after the problem?

(b) Will capable people come on board if they know the program is to have such a short life?

Answer:

The Administration's proposal calls for $50 million per year for the first three years. At the close of this initial period the program is to be evaluated and a determination made as to whether it should continue, and on what scale. Hopefully, the current problems of the thrift industry will decline significantly over this period and so large a program will not be necessary indefinitely. However, the Justice Department should be able to answer this question in more detail, since they devised the program.

QUESTIONS FOR SECRETARY BRADY
FROM
SENATOR JAKE GARN

Q.1. Recent press accounts have criticized the funding aspects of the plan for having unreasonably low interest rate assumptions. But isn't there an offsetting factor at work? While it is true that higher interest rates would make the interest payments on the new bonds more expensive, isn't it also true that the principal payments contributed by the industry would be less expensive? Wouldn't that free up some of the industry contribution to help pay for the higher interest costs?

Answer:

The interest rate assumptions for our plan were developed by the President's Council of Economic Advisors and OMB has used them for the entire budget.

You are correct in pointing out that a rise in interest rates has favorable, as well as unfavorable, results on Treasury's expenditures. Although the cost of interest payments on the REFCORP bonds would increase, the costs of repaying the $50 billion in REFCORP principal would decrease, thereby serving to offset the increased interest costs on the REFCORP bonds in the short-term. This would occur because a higher interest rate will allow a smaller initial investment (in zero coupon bonds) to compound over time and equal $50 billion when the REFCORP debt matures.

Q.2. Others have argued that your plan is unrealistic because it assumes a growth rate in deposits of 7 percent, while we all know that in the last few months thrifts have been losing deposits. But again, isn't there an offset at work? If depositors leave the thrift industry they are most likely to go to commercial banks, where the institutions will have to pay increased assessments on the new deposits. These of course are treated as budget receipts, so the net effect on the budget deficit would appear to be zero. Would you agree?

Answer:

First I would like to point out that the Administration's proposal would restore the thrift industry to health. We fully expect recent deposit outflows to be reversed as public confidence in the industry is restored. Over the past ten years the average annual growth rate in thrift deposits has been 9 percent. If an institution's average cost of funds is 7 percent, then interest-credited alone would result in a 7 percent annual increase in deposits. Therefore, we believe that our estimate of future annual deposit growth is realistic.

However, we do agree that if depositors were to leave the thrift industry, they would in all likelihood move their deposits to other federally insured institutions. To the extent that these deposits went to commercial banks, the banks would pay increased assessments on the new deposits. This would effectively result in a budget offset; there would be lower budget receipts from the Savings Association Insurance Fund, and increased budget receipts from the Bank Insurance Fund.

Q.3. Chairman Riegle and I led a fight during the CEBA legislation to exempt the bank and thrift regulators from Gramm-Rudman and OMB apportionment. We won, but OMB fought us every step of the way. In your regulatory restructuring, will any of the regulators become subject once again to either Gramm-Rudman or apportionment? I am very concerned that the Bank Board and Comptroller will be subject to federal pay and staffing restrictions, while the other bank regulators will not be restricted. How does the Administration plan address this issue?

Answer:

Sections 1103 and 702(e) of our proposed legislation remove all OCC and FHLBS employees, respectively, from federal pay restrictions.

We agree that all of the federal financial institution regulators, including the new FHLBS and the OCC, should be exempted from OMB apportionment and from Gramm-Rudman. Therefore, our legislation does not propose any changes in this regard.

Q.4. Your testimony is not entirely clear about one issue that has received a great deal of attention in the press. Exactly what sticker will banks and thrifts put on their doors to tell the public they are federally insured? Will the thrifts' sticker say "Savings Association Insurance Fund" (SAIF)? Will the banks' sticker say "Bank Insurance Fund" (BIF)? Or will banks still get to use the name "FDIC"?

Answer:

Our reform bill indicates that the signs displayed by banks and S&Ls will fairly represent which insurance pool they are in: the Bank Insurance Fund or the Savings Association Insurance Fund. The FDIC has existing discretion in this area to design the specifics.

Q.5. There have been plenty of complaints from the thrift industry about having to satisfy bank minimum capital requirements by 1991. But what really happens to those who don't quite make it, but are still profitable and still have capital? Wouldn't the regulators simply monitor them more closely and make sure that they had a reasonable plan in place to achieve the minimum standards without taking reckless gambles? What's wrong with that? Or are you also proposing that the FDIC be given new authority to require these thrifts to merge with someone else?

Answer:

No, we are not giving the FDIC new authority to require these thrifts to merge with someone else.

For those institutions that do not meet the minimum capital standards in 1991, the capital threshold is not a "make it or liquidate" standard. If a thrift has a realistic business plan and demonstrates substantial progress toward the capital standard, the appropriate federal regulator can use its supervisory capacity to extend the time period in which that thrift can achieve the capital objective. After June 1, 1991, however, the regulator must restrict the growth of any thrift that does not meet the capital standard.

Q.6. I am concerned about the zeal to put thrifts under bank accounting practices, with no deviations. I am not saying that thrifts should get off more leniently. I am only saying that certain characteristics of thrifts require regulations that are tailored to what thrifts do -- at least the traditional ones -- which is make mortgage loans. The Bank Board recently proposed a tough risk-based capital standard that takes into account interest-rate risks -- which the banks' regulation does not do. Interest-rate risk is a particular problem in the thrift industry, as you know. Will the new plan ignore this and other similar innovations? I have heard talk about imposing the more restrictive of the two, but that may be too severe. What is your view?

Answer:

I have testified to my strong support of thrifts as a separate and unique industry, devoted to providing housing finance. Along with this unique role, however, come unique risks, such as interest rate risk.

Consequently, our legislative proposal does not simply impose bank capital requirements on thrifts. Rather, it ensures that those standards applied to thrifts will be no less stringent than those applied to banks.

We did not define the phrase "no less stringent" because we believe that determination would be better left to the regulatory process. The important issue of capital standards requires the flexibility, expertise, opportunity for public comment, and the availability of case-by-case review that the regulatory process requires.

Q.7. My understanding is that while your plan will require thrifts to satisfy bank capital standards by 1991, you will also permit thrifts to count goodwill during a 10-year phase-out period. Some will no doubt criticize that , but a number of these institutions acquired goodwill through acquisitions of failed thrifts. It would be unfair to penalize them now. Also, banks do carry some goodwill on their books, especially bank holding companies. What is your view?

Answer:

We have proposed that thrifts write-off their goodwill over a 10-year period in Sec. 314. Only about 650 solvent thrift institutions currently have goodwill and 100 of these have 81 percent of the goodwill. We will, however, continue to evaluate the treatment of goodwill acquired in supervisory transactions.

Very little goodwill exists in the commercial banking industry.

QUESTIONS FOR SECRETARY BRADY
FROM
SENATOR WIRTH

Q.1. Secretary Brady, in prior hearings, I have raised concerns about the potential disruption and dislocation that the untimely disposal of assets currently held by the FSLIC could have on local economies and markets. While there has been a general recognition that the "dumping" of assets could have a devastating impact on local and regional economies -- particularly those already experiencing problems -- I have yet to hear any specific proposals or suggestions on how we might avoid such a result.

As I understand it, the Administration's proposal calls for the creation of a Resolution Trust Corporation (RTC) to be managed by the FDIC. The RTC would be responsible for managing the resolution of all insolvent thrifts and would take control of all assets currently owned by the FSLIC.

I am very interested in learning how the RTC will operate with regard to the assets it acquires from the FSLIC. For example, what specific safeguards will be in place to ensure that assets are not dumped in distressed economic markets?

What provisions and incentives are there in the resolution program to maximize the value of the assets to the government?

Do you believe the FDIC currently has the staff resources to administer the orderly disposition of assets?

What role, if any, do you see for the private sector in the management and disposal of assets currently held by the FSLIC?

Answer

Section 501 of the Administration's bill provides that the purpose of the RTC is: to carry out a program, under the direction of the Oversight Board, to manage and resolve all cases involving institutions, the accounts of which were insured by the Federal Savings and Loan Insurance Corporation, prior to enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, for which a receiver or liquidating conservator has been appointed or is appointed within the three-year period following the date of enactment of that Act; to manage the assets of the FADA; and to perform other authorized functions.

(a) The activities of the RTC will be under the direction of a three-member Oversight Board which can be expected to be sensitive to the orderly disposition of assets on local markets. The Oversight Board includes the Secretary of the Treasury (Chairman), the Attorney General of the United States, and the Chairman of the Board of Governors of the Federal Reserve System.

The Board is to review and have overall responsibility for the work, progress, management and activities of the RTC. It may disapprove, in its discretion, any and all regulations, policies, procedures, guidelines, contracts, and other actions of the RTC.

The Board is further required to approve or disapprove, in its discretion, any and all agreements for the purchase of assets and assumption of liabilities, any and all agreements for the acquisition, consolidation or merger, or any other transaction proposed by the RTC.

In addition, the primary manager of the Resolution Trust Corporation will be the FDIC. There is no evidence to date that the FDIC has engaged in the "dumping" of assets on local markets and there is no reason to think that the FDIC will significantly change its practices as an asset manager for the RTC.

(b) The FDIC, as primary manager of the RTC, can be expected to apply its current procedures and practices for the liquidation of bank assets to the thrift assets acquired by the RTC. The FDIC has an extremely thorough program for identifying, evaluating, and liquidating bank assets under its management.

In general, the FDIC has not found it productive to structure its liquidation practices around speculation about the future shape of the "yield curve." Rather, the FDIC prefers to establish the market value of assets and then promptly dispose of those assets accordingly.

Also, the RTC Oversight Board will have the authority to alter RTC liquidation practices if it is convinced that liquidation value is not being maximized.

Finally, it must be recognized that the "value" of the resolution program goes far beyond the monies directly collected through asset liquidations. The real benefits derive from the prompt identification and control gained over insolvent thrift institutions. Only in this way can the growing cost of resolving the thrift industry problem be contained.

(c) In all likelihood the FDIC will have to increase its staff resources to manage the liquidation of assets under the RTC in addition to its existing bank liquidation caseload. The extent of this increase, however, is uncertain at this time, and will depend greatly upon:

-- the condition of the assets of insolvent thrifts which are taken over by the RTC;

-- the exact workload assigned to the FDIC by the chief executive officer of the RTC; and

-- the terms, conditions, and standards established by the RTC for the liquidation of thrift assets.

Currently, the FDIC has approximately 3,500 individuals involved in its bank closing and asset liquidation functions. FSLIC directly employs about 250 individuals in closing/liquidation functions; but FSLIC also has call on the liquidation resources of about 300 FADA employees and approximately 1,200 private contractors.

This sum total of about 5,250 individuals is engaged in the workout of existing bank and thrift insolvencies. At least initially, the need to manage another 500 insolvent institutions under the RTC would probably require additional staff resources. Over time, however, the benefits of consolidated administration ought to manifest itself in the more efficient use of personnel and, as the "problem cases" get cleaned up, a rather rapid reduction of personnel in the closing/liquidation function ought to be achievable.

(d) About 1,200 private contractors are currently assisting FSLIC in the liquidation of existing cases. In all likelihood, these contractors will continue to fulfill existing commitments even under an administrative merger of the insurance funds. The extent to which the RTC will engage private contractors will depend upon the specific operating rules and guidelines established by the Oversight Board and the Chief Executive Officer. But it is almost certain that in the initial stages of its operation, the RTC will make rather substantial use of private contractors in order to make significant inroads on its caseload.

Q.2. Under the Administration's proposal, the Resolution Trust Corporations (RTC) would be authorized to "analyze" any agreement the FSLIC completed in 1988.

Would the RTC have the authority to reopen the agreements completed in 1988 and, if appropriate, restructure those agreements?

What is the timeframe contemplated in the Administration's proposal for reviewing the FSLIC agreements completed last year.

Answer:

(a) Section 501 of the Administration's bill gives the RTC the explicit power "to review and analyze all insolvent institution cases resolved by the Federal Savings and Loan Insurance Corporation since January 1, 1988, through the date of enactment of this Act, and to actively review all means by which it can reduce costs under existing Federal Savings and Loan Insurance agreements, including through the exercise of rights to restructure such agreements, subject only to the monitoring of the Oversight Board."

(b) A specific timetable for reviewing the 1988 FSLIC agreements will be established by the management of the RTC once that agency is up and running. Clearly, however, the earliest possible review of those agreements will be a top priority for the RTC.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

March 24, 1989

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing,
  and Urban Affairs
United States Senate
Washington, D. C.   20510

Dear Mr. Chairman:

Thank you for your letter of March 2 enclosing written questions in connection with the hearing held on February 23 on the Administration's proposal and the problems facing the savings and loan industry. I am pleased to enclose my responses to the questions for inclusion in the record of the hearing.

In addition, I have sent a letter to Senator Garn enclosing my responses to his questions.

I hope this information will be useful to your Committee. Please let me know if I can be of further assistance.

Sincerely,

Enclosures

Chairman Greenspan subsequently submitted the following in response to written questions from Chairman Riegle in connection with the hearing held on February 23, 1989:

Question 1: In testifying before the Committee on February 28, 1989, Chairman Seidman of the FDIC suggested that -- although it might be appropriate to restrict the activities that a federally insured thrift institution may conduct directly -- such an institution should have broad freedom to conduct other activities through a subsidiary or through a nonthrift subsidiary of the thrift institution's parent holding company ("affiliate"), subject to appropriate firewall provisions. Mr. Seidman appears to believe that, from the standpoint of public policy, it makes no difference whatever whether nonthrift activities are conducted in a subsidiary or in an affiliate. Do you believe that it is appropriate to draw a distinction between the activities permissible for a subsidiary of a federally insured depository institution and the activities permissible for an affiliate of that institution? Why?

Answer: We at the Board have urged that banking organizations should, in order to maintain their competitive viability, be permitted to expand their activities in response to the challenges and opportunities that computer and communications technology and market forces are creating in the financial services marketplace, both domestically and abroad. That expansion, however, must be soundly grounded upon a framework that insures that new activities are conducted in a manner fully consistent with traditional and essential concepts of bank safety and soundness, avoidance of conflicts of interest, partiality in the credit granting process, and unfair competition, and the minimization of undue risk to the resources of the federal safety net.

The Board has considered the complex issues of expanded powers in the light of these important and fundamental concepts over a number of years and in a variety of situations. After much deliberation and study, we have concluded that an expansion in the powers of banking organizations in a manner that is faithful to these essential public policy objectives is most likely to be achieved through the use of a holding company organizational structure rather than through the bank-subsidiary structure.

In our view, that framework, strengthened by appropriate firewalls, provides an insulation and protection for the federal safety net that is likely to be far more effective and capable of being supervised and enforced than an organizational structure that allows the expanded, and particularly higher risk, activities to be conducted through a subsidiary of a federally insured depository institution. The holding company organizational format also provides a more effective structure to address the potential for harmful conflicts of interest and competitive imbalances and inequities that might flow through close association of the expanded activities with the resources and support, direct or indirect, of the federal safety net.

The debate over whether the expansion of powers should be channelled through subsidiaries of depository institutions or through holding company affiliates is over the degree and effectiveness of the insulation offered under the two approaches, not over the purpose for an insulating structure. Both approaches seek the same objective -- the separation to the greatest extent possible of corporate conduct that poses undue risks to federally insured institutions and the federal safety net. Both approaches rely on the doctrine of corporate separateness, that is, the rule that separately incorporated companies are normally not liable for the actions of one another even if they are commonly owned or one is a subsidiary of the other.

The difference between the two approaches lies, in our view, in one basic but important point. The holding company structure, in our view, provides for more effective separation, and thus protection for the resources of the federal safety net, than is the case with the bank/thrift-subsidiary organizational structure. Given the past experience with expanded powers through the bank/thrift-subsidiary relationship, and the potential risks and conflicts of many of the non-traditional powers, we believe caution dictates that expansion into non-traditional, potentially higher risk activities should take advantage of the superior protection afforded by the holding company organizational structure.

The greater effectiveness of the holding company format derives from the fact that it offers the ability to separate from the bank or thrift the ownership, financial, managerial and operational control of the expanded activity and thus the potential for transference of the risk to the bank or thrift and the federal safety net. This ability to insulate control of the activity from the bank or thrift is not achievable in the bank-subsidiary structure. Ownership, financial, managerial and operational control is inherent in the bank-subsidiary relationship and would form the basis for the claim that the parent bank or thrift is responsible for obligations or activities of the subsidiary, particularly when the subsidiary's justification for existence is that it is acting as a department or division or service corporation of its parent bank or thrift.

The insured bank or thrift owns the subsidiary, supplies the capital and funding necessary for it to operate, appoints its board of directors, establishes the overall management and policies of the subsidiary, and maintains operational control and supervision. Losses from the subsidiary are directly reflected in the income, capital and operating accounts of the bank or thrift. In many cases, the activities of the subsidiary are closely coordinated with those of the bank or thrift, and large transactions frequently require approval by management of the bank or thrift. Experience also suggests there may be confusion of roles and uncertainty as to whether an employee of the bank and its subsidiary is acting for the bank or the subsidiary.

The holding company format, on the other hand, separates the insured bank or thrift from this control and takes maximum advantage of the legal doctrine of corporate separateness, thereby providing enhanced insulation for a bank or thrift affiliate from liability for losses experienced as a result of activities conducted through the holding company affiliate. The bank or thrift has no ownership interest in the holding company affiliate; the holding company owns the affiliate. The bank or thrift does not provide the capitalization for the affiliate from insured depositor funds or otherwise; the holding company must provide that capitalization from funds it raises and that are not necessary for the support of its subsidiary banking or thrift institutions. The bank or thrift does not appoint the board of directors or the management for the affiliate or establish its policies and operational controls. These functions are carried out by the holding company. Importantly, any losses from the activities do not show up in the financial statements of the bank or thrift and are not consolidated with the bank's or thrift's earnings, but rather with those of the holding company.

In contrast to this situation, there are no firewalls or operating conditions that can be devised that would eliminate the ability of the bank or thrift to control and direct the management and activities of its subsidiary or to prevent losses from its activities from being reflected in the earnings and capital accounts of the bank or thrift. The imposition of necessary firewalls such as lending and asset exchange limitations and prohibitions against mixing the insured institution's and its subsidiary's business are more easily applied and supervised in the holding company structure, which establishes a more distinct legal separation between the bank or thrift and the subsidiary.

The holding company format also directly addresses in a more effective way the financial incentives that the owner of a bank or thrift institution would have in periods of stress to assist the endangered subsidiaries, as well as the linkage in the public's eye -- either correctly or incorrectly -- that the bank or thrift may be responsible for the obligations of the subsidiary. The control necessarily present in the bank-subsidiary relationship provides a natural and powerful incentive for management of the institution to take necessary steps -- with federally insured funding support -- to protect its investment in the subsidiary as well as the institution's reputation for financial stability in the market. Indeed, these market pressures and inducements for a bank or thrift to act to protect its investment in the subsidiary and its reputation are greatest in times of crisis -- exactly when the need for insulation of the insured institution is greatest. The combination of the ownership and operational and financial control of the subsidiary by the bank or thrift makes it less likely that the federally insured institution will walk away from a troubled subsidiary. While the pressures are present in the holding company organizational structure, they are more removed from its bank or thrift affiliates and are directed at a nonbank entity that is not federally insured or supported by the federal safety net and that would not provide funds from public deposits.

Regulatory experience with the bank-subsidiary relationship illustrates this problem. For example, during the stock market decline of October 1987, when customers of First Options of Chicago failed to meet margin calls and First Options was unable to obtain funding from unaffiliated lenders, its parent, Continental Bank, stepped in with an immediate, unsecured loan of $500 million. The firewall that had been established to prevent such lending failed to function when it was needed most -- when the stock market crisis should have dictated enhanced insulation of the bank from its affected subsidiaries.

Even were a situation to arise where a bank or thrift operating subsidiary or service corporation were permitted to fail, the direct ownership, financial and operational control that tie the insured institution to its subsidiary lays a foundation for a claim that the corporate veil should be pierced and the parent institution and thus the resources of the federal safety net should be liable whether or not there is any breach in insulating firewalls. Thus, the potential is there for extensive liability transference to the parent bank or thrift as a result of the degree of the ownership, financial, managerial and operational control.

In sum, the bank/thrift-subsidiary relationship, while providing a greater degree of protection than is present when the activity is conducted directly by a bank or thrift, suffers from the inherent and unavoidable defects of close ownership, financial, managerial, and operational control.

These are also the basic ingredients that establish the incentive for the bank or thrift to support the subsidiary, particularly in times of stress. While firewalls of various types and kinds have been devised to address aspects of the potential safety and soundness and conflict of interest concerns in such relationships, firewalls cannot fully address this inherent structural flaw. The holding company framework, on the other hand, does not suffer from this flaw, and the necessary firewalls are more likely to be effective and to achieve their objective of safeguarding our financial institutions and financial system.

The argument is made that the bank/thrift-subsidiary organizational framework permits gains realized by the subsidiary to be realized by the parent bank or thrift. That is certainly true but, as noted, it also requires that the bank or thrift realize the losses. In the holding company framework, the losses are not recognized by the bank or thrift or consolidated with its financial reports. Although losses would reduce the ability of the holding company to serve as a source of strength to its banks and thrifts, there would be no immediate impact on the condition of the insured institution. Moreover, in the holding company format, the resources and the earnings from these expanded powers would be available to support the financial strength of subsidiary banks and thrifts. The bank or thrift subsidiary thereby obtains the advantages of its parent holding company's diversification without the disadvantages that may flow from the bank or thrift conducting the activity directly or through a subsidiary of the bank or thrift.

Question 2: In testifying before the Committee on February 28, 1989, Comptroller Clarke cited the FDIC's securities subsidiary regulation as a model of the types of firewall restrictions that, in his view, would make it safe to conduct virtually any activity through a subsidiary of a bank. Please compare and contrast the restrictions in the FDIC's regulation with those imposed by the Federal Reserve Board on bank holding companies that underwrite ineligible securities pursuant to section 4(c)(8) of the Bank Holding Company Act.

Answer: The FDIC's securities subsidiary regulation relies on separate incorporation of the activities in a subsidiary of the bank, supplemented by certain limitations on transactions involving the bank, to insulate the bank from the potential risk of the activities of the securities affiliate. The holding company affiliate structure, under which the Board has authorized bank holding companies to underwrite certain securities to a limited extent, is distinguishable in four main ways:

(1) there is no ownership by the bank of the underwriting subsidiary;

(2) the underwriting affiliate is financially independent of the bank -- the capitalization and funding for the affiliate is not supplied by the bank and underwriting losses would not be reflected in the income, capital and operating accounts of the bank;

(3) there is no management control of the underwriting subsidiary by the bank; and

(4) the operations and policies of the underwriting subsidiary are not under the control of the bank.[1]

The FDIC regulation does not contain all of the firewalls established in the Board's Order to strengthen the structural separation between the potential risk and conflicts of the non-traditional activity and the bank that is provided by the holding company system of organization. The principal differences between the firewalls established in the Board's Order and those contained in the FDIC regulation are that the FDIC regulation --

--permits bank lending, subject to section 23A of the Federal Reserve Act, to the securities subsidiary and the purchase and sale of financial assets between the bank and the subsidiary;

-- does not require, in advance of establishing the subsidiary, a demonstration that the bank will remain strongly capitalized after the capital invested by the bank in the subsidiary is deducted from regulatory capital;

-- does not require prior agency approval for additional funding by the bank of the subsidiary;

--does not prohibit loans by the bank to pay principal, interest or dividends on securities previously underwritten by the subsidiary;

-- does not place restrictions on use of lines of credit extended by the bank to the issuer in advance of the underwriting and does not explicitly prohibit credit enhancement by the bank for an issue underwritten by the subsidiary;

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[1] J.P. Morgan & Co. Incorporated, et al., 75 Federal Reserve Bulletin 192, 202 (1989).

-- does not restrict the subsidiary from underwriting securities backed by bank assets or impose conditions on such underwriting, such as an independent rating of the assets;

-- does not restrict the bank from purchasing for its own account securities being underwritten by the subsidiary;

-- does not limit transfers of nonpublic customer information between the bank and the securities subsidiary; and

-- permits director and employee interlocks between the bank and the securities subsidiary.

It should be noted that the FDIC, in adopting this regulation, did not waive its right to address, on a case-by-case basis, practices, conduct or acts it may find to constitute unsafe and unsound practices.

Question 3: Concern has been expressed (a) that stronger capital standards could cause many marginally healthy thrift institutions to fail, and (b) that these additional failures would increase the cost of dealing with FSLIC's problems. What is your response?

Answer: Stronger capital standards will help to strengthen thrift institutions, not cause more to fail. The serious problems in the thrift industry have, in part, developed as a result of inadequate capital for savings and loan institutions.

Thrift institutions will be required to meet bank capital requirements by June 1991, with the exception of a ten year period for writing off goodwill. If an institution is healthy and profitable, it should be able to attract and maintain adequate capital. If it has trouble doing this, asset growth could be curtailed, or the institution may have to shrink, in order to meet the capital standards. Obviously, if an institution is unable to remain or become solvent even after attempts have been made to restrict growth and shrink the balance sheet, it may have to close.

Strengthening thrift industry capital standards generally and requiring weak institutions to restrict growth or shrink in size until they meet the required minimum capital levels, are necessary steps to assure that thrift institutions remain sound and able to serve the public by providing a reliable source of residential housing finance. A more strongly capitalized thrift industry will decrease, not increase, the potential costs to the government of addressing the problems confronting thrift institutions.

Question 4: Concern has been expressed that the FDIC's authority to increase insurance premiums to 35 cents per $100 of insured deposits would discourage investment in banks and thrift institutions. (a) What is your response? (b) Is that authority really needed? If so, why?

Answer: Obviously, the administration of the insurance fund and the establishment of fund premiums will require a balancing of a number of considerations. There is, no doubt, a level above which insurance premiums could put depository institutions at a competitive disadvantage and discourage investment. On the other hand, there needs to be some flexibility for the insurer to set reasonable premiums in light of industry loss experience. In view of these considerations, the provisions contained in the proposed legislation, including the maximum 50 percent premium increase in any one year and the cap at 35 basis points, does not seem unreasonable.

Question 5: Under section 601 of the Administration's proposed bill, a bank holding company could acquire a failed or failing thrift institution (or, after two years, a healthy thrift institution) without being subject to certain restrictions that have been imposed in the past by the Board. If a bank holding company acquired a thrift institution pursuant to section 601, would the bank holding company be free to engage through the thrift institution (or its subsidiaries) in any activities in which the thrift institution (or its subsidiaries) was otherwise authorized to engage? For example, could the bank holding company engage through a subsidiary of the thrift institution in underwriting and selling insurance, underwriting and dealing in corporate securities, and developing real estate, all without regard to the restrictions that would otherwise apply under the Bank Holding Company Act?

Answer: Section 4 of the Bank Holding Company Act permits a bank holding company to acquire a nonbanking company, such as a thrift institution, only where all of the activities of the nonbanking company are "closely related to banking and a proper incident thereto" or are otherwise permissible under the Bank Holding Company Act. In accordance with the terms of the Act, the Board has conditioned its approval of all applications by bank holding companies to acquire failed of failing thrift institutions on the requirement that all of the activities of the thrift institution, including activities carried on directly by the institution and activities conducted indirectly through a subsidiary of the thrift, conform to the nonbanking requirements of the Bank Holding Company Act.

This requirement permits thrifts to continue to engage in all of the traditional depository, lending, trust, and similar activities that represent by far the greatest portion of their business. Only non-traditional, higher risk activities that have not been permitted for bank holding companies or for national banks would be affected by this requirement. As a result, a bank holding company that acquires a thrift institution would not be permitted to engage through that thrift institution, or a subisidiary service corporation of the thrift, in underwriting and selling insurance, underwriting and dealing in corporate debt and equity securities, developing real estate, making equity investments in any company, or any other nonbanking activity, unless the activity is permissible for bank holding companies under the Bank Holding Company Act. Of course, thrift institutions acquired by bank holding companies would be able to conduct insurance activities to the extent that those activities are permissible for bank holding companies within one of the exceptions provided in section 4(c)(8) of the Bank Holding Company Act by the Garn-St Germain Act.

The requirement that thrift institutions acquired by bank holding companies limit their activities to those permissible under the Bank Holding Company Act is necessary in order to prevent thrift institutions from serving as a vehicle for circumvention of the requirements of the Bank Holding Company Act by conducting activities through the thrift that the bank holding company is otherwise prohibited from conducting directly under the Bank Holding Company Act. Without this requirement, a bank holding company could, for example, conduct through the holding company's thrift institution real estate investment and development activities that are not currently permitted under the Act or the Board's regulations because of safety and soundness concerns.

In addition, the Board has authorized bank holding companies to conduct a number of activities only upon the condition that the activity be conducted in a nonbanking corporation in which a federally insured depository institution has no ownership, financial, management or operational control. The Board believes that this structure is important for insulating federally insured depository institutions from the risks associated with non-traditional, higher-risk activities and for assuring that the federal safety net is not used to support these activities. Bank holding companies would be able to evade these firewall provisions by conducting otherwise limited activities under authority granted to the thrift under state law.

The Board has generally permitted thrift institutions acquired by bank holding companies a period of two years in which to conform their activities to the nonbanking restrictions of the Bank Holding Company Act. This requirement does not appear to have raised any significant disincentive for bank holding companies to acquire troubled thrift institutions.

Question 6: Under the Administration's proposal, the FDIC's Board of Directors will be expanded from three members to five, and the Comptroller of the Currency and the Chairman of the Federal Home Loan Bank System will be members *ex officio*. On February 12, 1989, the New York Times reported that the Federal Reserve Board had sought to have its Vice Chairman included on the FDIC board, but that its request had been rejected. (a) Did the Federal Reserve Board seek representation on the FDIC board? (b) If so, what reasons were given for denying the request?

Answer: In developing the Administration's legislative proposal for the thrift crisis, the Board participated in a number of discussions with the Treasury and other agencies regarding various aspects of the proposal, including the composition of the board of directors of the Federal Deposit Insurance Corporation and many related issues. In the course of those discussions, the idea was raised of having a Federal Reserve Governor sit as a member of the FDIC board of directors. The final Administration proposal did not incorporate this option. That decision was arrived at with the agreement of the Federal Reserve and in the context of discussions and compromises on a wide range of issues associated with the Administration's proposal.

Question 7: You made a strong statement in your earlier testimony (February 21), in favor of the unified budget. Why shouldn't the thrift rescue plan be included in that budget? How much extra do you estimate it will cost to issue more FICO bonds and new REFCORP bonds instead of Treasury bonds to finance this plan?

Answer: Two distinct questions arise regarding the budgetary treatment of the thrift rescue plan. First, should expenditures made under the plan be subject to the constraints imposed by the Balanced Budget (Gramm-Rudman-Hollings or G-R-H) Act? Second, what is the best way to exclude such expenditures from those constraints? A strong argument can be made for excluding such expenditures from the G-R-H constraints. The plan does not constitute a new commitment of resources. Rather, it provides funding for the federal government's existing commitment to the holders of FSLIC-insured deposits, a commitment with a cost that has grown steadily over recent fiscal years and could appropriately be assigned to the earlier years in which it was accruing. In effect, a direct claim on the federal government would be substituted for the indirect claim that already exists.

The rescue plan could be excluded from the G-R-H constraints either through a direct exemption or through the use of an off-budget financing vehicle. In my judgment, the off-budget vehicle is clearly superior to a direct exemption because it is less likely to undermine the budgetary discipline of the G-R-H constraints.

Financing costs associated with the off-budget vehicle clearly are higher. The Board's staff estimates that REFCORP bonds, for example, would carry yields about 30 basis points higher than 30-year Treasury bonds. This would imply additional interest costs of $150 million per-annum, or $4.5 billion over the 30-year life of the bonds. However, the present value of these higher interest payments, which is the most appropriate measure of the cost, is much less, around $1.4 billion.

Question 8: Are the deposit growth rate assumptions in the Treasury proposal consistent with the interest rate assumptions? Presumably if interest rates plummet as the Treasury projects, inflation must slow to a crawl. But if it does, how will the deposit bases of both FDIC and FSLIC grow at 7 percent per year?

Answer: The deposit growth rates assumed in the Treasury proposal may well be consistent with the assumptions for interest rates. Declining interest rates, by themselves, would boost deposit flows at banks and thrifts. This occurs because the rates on most retail deposits move considerably more slowly than market interest rates, and as market rates decline deposits would become much more attractive savings instruments. Some of the projected interest rate declines in the Administration's forecast results from an assumption that the President's budget proposal would be adopted quickly, supplementing the effect of lower inflation. With market rates declining substantially under these circumstances, strong deposit growth for a period would not be inconsistent with progress toward price stability. To be sure, over the longer run, deposit growth would need to slow to a pace commensurate with the reduced inflation rate.

Question 9: How much of a shrinkage in the thrift industry would you anticipate as a result of the increased capital standards which must be met by June 1, 1991? Would you expect that, a smaller, less competitive industry would raise homebuyers mortgage costs appreciably?

Answer: It seems clear that certain institutions whose capital is inadequate may have to curtail growth or reduce their assets. In particular, prior to 1991, thrifts that don't meet the bank guidelines will have to restrict their growth; after that time, their growth may be stopped until they can raise additional capital or retain sufficient earnings to meet the minimum standard. Some institutions, whose profitability or prospects are poor, may be required to shrink until they reach a size that can be supported by their capital bases.

It is difficult to say with precision what will be the impact of these capital requirements in terms of future asset growth for the industry as a whole. For example, the need for asset growth restrictions will be mitigated to the extent the industry can issue new capital instruments or generate capital through retained earnings. Moreover, the implications for asset growth will be minimized if significant amounts of additional capital are attracted from outside the industry. Finally, while many thrifts are below the minimum levels specified in the bank guidelines, other thrifts are above bank minimums and will be in a position to continue prudent growth. In the end, of course, the industry's future course will be based upon its ability to attract and retain capital -- a fundamental principle that underlies our free market economy.

The application of more stringent capital requirements to the thrift industry likely would have little if any adverse effects on the cost or availability of home mortgage credit. The share of home mortgage debt held by thrifts could well shrink, but other lenders could be expected to quickly fill any vacuum. It is important to realize that thrifts' market share has already shrunk from a peak of 57 percent in 1978 to 42 percent last year and there is no evidence that this decline in the thrift share has led to an increase in primary mortgage rates over comparable market rates or lessened availability of mortgage credit. An important factor underlying this development has been the securitization of home mortgage credit, which has broadened and deepened the market by promoting the entry of nontraditional mortgage investors.

Question 10: The FHLBB has reported that most of the FSLIC notes and virtually all of the yield maintenance and capital loss agreements are immediately callable. The Administration's plan does not appear to allow for any refinancing of these liabilities. Should it, in your judgment?

Answer: The Administration's plan requires the RTC to analyze all FSLIC transactions completed since January 1, 1988 and to restructure those transactions if doing so would reduce resolution costs. Adequate funds are in fact available to refinance liabilities incurred in those earlier transactions. The FSLIC Resolution Funding Corporation, which would assume FSLIC's existing liabilities, would have an unlimited backup funding commitment from the Treasury that it could draw on to prepay FSLIC's obligations. This would of course result in an acceleration of Treasury payments to FSLIC Resolution Funding Corporation, but prepayments would occur only if doing so reduced costs--that is, if the total discounted present value of payments would be reduced. Thus, increased payments in earlier years would be more than offset by lower payments in later years. In this regard, it should be recognized that the Treasury's cost estimates are merely projections rather than inflexible commitments.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

March 24, 1989

The Honorable Jake Garn
Ranking Minority Member
Committee on Banking, Housing, and
  Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator:

In response to a request from Chairman Riegle, I am pleased to enclose my responses to the written questions you submitted in connection with the hearing held on February 23 on the Administration's proposal and the problems facing the savings and loan industry.

I have also sent a copy of this response to Chairman Riegle for inclusion in the record of the hearing.

I hope this information is useful. Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Chairman Greenspan subsequently submitted the following in response to written questions from Senator Garn in connection with the hearing held on February 23, 1989:

Question 1: I am concerned about the zeal to put thrifts under bank accounting practices, with no deviations. I am not saying that thrifts should get off more leniently. I am only saying that certain characteristics of thrifts require regulations that are tailored to what thrifts do -- at least the traditional ones -- which is make mortgage loans. The Bank Board recently proposed a tough risk-based capital standard that takes into account interest-rate risks -- which the banks' regulation does not do. Interest-rate risk is a particular problem in the thrift industry, as you know. Will the new plan ignore this and other similar innovations? I have heard talk about imposing the more restrictive of the two sets of rules in any situation, but that may be too severe. What is your view?

Answer: As a general matter, banks and thrifts should be subject to consistent and realistic accounting practices that are designed to accurately reflect the institutions' financial condition and operating performance. Banks and thrifts should also be subject to consistent, reasonable, and prudent minimum capital requirements. The risk-based capital guidelines accommodate an important feature that is characteristic of many thrifts and banks. In particular, the framework places residential mortgage loans and certain mortgage-backed securities in low risk categories (effectively requiring significantly less capital than a normal commercial loan).

As pointed out in the question, the bank risk-based capital guidelines do not take explicit account of interest rate risk, although these risks are evaluated during on-site examinations and institutions with undue exposure will be expected to operate above minimum levels. It should be emphasized that the bank risk-based minimum is firmly set at 8 percent (after 1992), while the Bank Board's thrift measure, as we understand it, is in the proposal stage and sets a 6 percent benchmark for credit risk and an interest rate add-on factor that would amount to an additional 2 percent for an average thrift.

We would not favor, as a general rule, a complex capital regime that imposed the more restrictive of two sets of risk-based capital rules. Rather, we believe the bank guidelines provide a reasonable base from which to assess the capital adequacy of depository institutions. It should be noted that these guidelines specify minimum capital ratios; institutions with excessive risks, including undue interest rate exposure, would be expected to operate above the minimums.

It is certainly appropriate for the banking agencies to consider proposals to factor more directly interest rate risk into bank capital standards, and it may also be appropriate to retain the interest rate add-on factor, or some variation of this approach, for thrifts once the proposal has been fully reviewed and comments evaluated. Moreover, it may also be necessary to retain some overall leverage constraint (i.e. minimum capital-to-total assets ratio) in order to limit total borrowing -- one activity that can, if carried to excess, exacerbate interest rate exposure. In the end, of course, the capital standards must be realistic and prudent -- high enough to provide a reasonable cushion to promote stability, protect the deposit insurance system and prevent a recurrence of the types of problems we now face, yet not so high as to place banks and thrifts at an undue competitive disadvantage.

Question 2: Many have criticized certain accounting practices of thrifts, especially the practice of lending the full amount of principal, several years of interest, and certain loan fees in connection with real estate development deals. That permits a developer to use borrowed money to pay interest and loan fees before any revenue is generated by a development project. It also permits the S&L to book the return of the money just lent as "profit" that it can use to pay massive dividends to insiders. I have several questions: First, isn't it true that bank real estate loans are accounted for the same way? Second, should Congress put a stop to the practice for both thrifts and banks? Finally, should borrowers be required to guarantee repayment personally in addition to using the real estate collateral? Wouldn't that help curb speculative ventures while at the same time giving the institution and the insurance fund a better chance of recovery in the event of losses?

Answer: The practices to which the question refers, including the upfront recognition of fee income, lending on projects with thin or nonexistent developer net worth cushions, and advance lending of funds to pay interest, are generally inappropriate and unsound. Such practices have led to serious and widespread problems for many thrift institutions. Moreover, while these practices have generally been addressed and discouraged by bank supervisors, they have resulted in problems for some banking organizations as well.

Certain accounting practices that allowed for improper and inaccurate income recognition have been addressed by the Financial Accounting Standards Board ("FASB"), which issued Statement No. 91 in 1986. This pronouncement sets forth accounting standards for loan fees for banks, thrifts and all other lenders. As of January 1, 1989, this Statement became effective for thrifts (it was adopted by banks on January 1, 1988). Statement No. 91 generally prohibits the recognition of loan fees upfront and requires these fees to be recorded as income over the life of the related loan. The adoption of this Statement has provided for more conservative accounting treatment for real estate and other loans in both the thrift and banking sectors.

More broadly, lending on thin or nonexistent borrower equity cushions and advance lending of funds to pay interest must be carefully evaluated and addressed through the supervisory and on-site examination processes. As a general matter, real estate development loans should only be granted if the developer as a corporate entity has an adequate level of capital at risk in the project and the project can reasonably be expected to generate sufficient cash flow to service the loan. Indeed, the security (collateral) on these loans is a function of the cash flow and income that the project can produce over time. Beyond the financial capacity (net worth) of the corporate borrower and the project's cash flow, it may indeed be appropriate and desirable for the lending institution to further secure its position by obtaining the personal guarantee of the individual developer, and lenders should be encouraged to do this. However, in the absence of strong economic and credit fundamentals underlying the real estate project, experience suggests that personal guarantees may be of questionable value.

Because of the judgments that must be made in evaluating many of these practices and their potential impact on the lending institutions, we do not believe that additional formal requirements are appropriate at this time. As indicated above, the FASB has addressed the upfronting of fee income. Moreover, supervisors already have the responsibility and authority to address and prohibit unsafe and unsound banking practices. The practices referred to in this question can best be addressed by strengthened examination and supervisory techniques rather than by the imposition of new legal requirements.

Question 3: Many have spoken frequently of the "moral hazard" that occurs when a federally-insured depository institution's capital has been substantially depleted. The managers of such an institution have an incentive to make risky investments because they no longer have a substantial amount of capital that they would lose if the investments went sour. Isn't the same "moral hazard" present when an institution's market value capital drops substantially, even if its GAAP capital does not? If so, should Congress require depository institutions to begin some form of market value reporting?

Answer: The moral hazard problem is a serious one and certainly the incentives that give rise to this problem could be present or intensified when the market value of an institution's capital falls to a low level. In this connection, reliable and meaningful data on the market value of assets can be particularly valuable in assessing an organization's overall financial condition, and banking organizations are generally required to mark their trading account assets to market and disclose the market value of their investment securities. Market value reporting with respect to loans, however, raises many more difficult issues since meaningful market prices for loans generally are not available. Even more complex questions are raised to the extent that consideration of market value reporting leads to the broader issue of market or current value accounting. In this connection, it should be noted that the feasibility of market value accounting is one of the prescribed topics of the study of deposit insurance and banking regulation proposed in the President's thrift industry recovery and reform legislation. Any move away from historical cost accounting could have significant and far-reaching implications for banking and thrift institutions. Thus, it would appear appropriate to await the outcome of this study before any further Congressional action is considered.

Question 4: In 1985, you testified before the House Banking Committee that direct investments by savings and loans in such areas as real estate, equity securities and service corporations constitute an investment option that is necessary to the financial health or even survival of savings associations. Do you still hold this view? If so, what restrictions, if any, would you impose on such direct investment activities?

Answer: My main concern in 1985 was with the maturity mismatch which threathened the solvency of thrifts. Direct investments, under appropriate supervision, could lessen that mismatch. More generally, I believe that it is important for banking organizations, including thrift institutions, to have the flexibility to take advantage of the new opportunities that are presented as computer and communications technology and competitive forces change the financial services marketplace, both domestically and abroad. Because these institutions are backed by federal deposit insurance and other elements of the federal safety net, these opportunities should be made available within a framework of prudential limitations and supervision that are designed to ensure that the activities are conducted in a manner consistent with the fundamental public policy of promoting the safety and soundness and competitiveness of the nation's depository institutions, guarding against harmful conflicts of interest, preserving impartiality in the credit creating process, and minimizing undue risk to the resources of the federal safety net.

To this end, the Federal Reserve Board has recommended expansion of bank powers through the holding company organizational framework with the capital requirements and other types of protections that are designed to meet the important and fundamental public policies noted above coupled with a program for sound supervision to ensure observance of the necessary regulatory controls. This holding company organizational structure should be used to institutionalize separation to the greatest extent possible between a federally insured depository institution and the potential for risk and conflicts of interest that may be posed by expanded powers.

To strengthen this separation, the Board has, in the securities underwriting cases, for example, relied on firewalls to prohibit lending to or for the benefit of the affiliate, the purchase and sale of financial assets between the depository institution and the affiliate, and the provision of credit enhancements for the products and services of the affiliate. The Board has also prohibited investment in the affiliate of resources needed by the parent bank holding company to support its federally insured depository institution subsidiaries, required adequate capitalization for the underwriting affiliate in accordance with industry norms or rules, required disclosure that the affiliate's obligations are not federally insured or guaranteed by its affiliated federally insured banks or thrifts, and established appropriate limitations on employee and management interlocks.

Question 5: In S. 1886, the Senate approved the concept of isolating certain activities from an insured depository institution through the use of a "separate affiliate" and "firewalls." What is

> your view about this approach in general and do you believe this model could be useful with respect to the more risky activities of savings associations?

Answer: The Board believes an approach similar to that provided for in S.1886 -- a holding company organizational structure supported by "firewall" restrictions on capitalization, supervision, transactions, funding and relationships with affiliate federally insured depository institutions -- is the framework most likely to achieve the public policy objectives of insuring that expanded powers of banking organizations are conducted in a manner fully consistent with bank safety and soundness, avoidance of conflicts of interest, partiality in the credit-granting process and unfair competition, and minimization of risk to the resources of the federal safety net.

As discussed in the response to a related question from Senator Riegle, that framework, strengthened by appropriate firewalls requiring sound capitalization and limits on transactions, particularly credit transactions, between the insured institution and the activity, provides an insulation and protection for the federal safety net that is likely to be more effective and capable of being supervised and enforced than an organizational structure that allows the expanded activities to be conducted through a subsidiary of a federally insured depository institution. The Board relied on this general approach in recently authorizing several bank holding companies to engage to a limited extent in underwriting and dealing in corporate debt securities. J.P. Morgan

& Co. Incorporated, et al., 75 Federal Reserve Bulletin 192, 202 (1989).

To summarize our analysis of this issue, the holding company format offers the ability to separate from the depository institution the ownership, financial, managerial and operational control of the expanded activity and the potential for transference of the risk of the non-traditional activity to the depository institution and the federal safety net. The holding company format achieves this objective by taking maximum advantage of the legal doctrine of corporate separateness. In addition, the holding company format addresses to a greater extent than the bank-subsidiary organizational structure the financial incentives the owner of a bank would have in periods of stress to assist an endangered subsidiary. While these pressures are present in a holding company organizational structure, they are more removed from the bank and are directed at a nonbank entity that is not federally insured or supported by the federal safety net.

The holding company organizational approach also provides a more effective structure to address the potential for harmful conflicts of interest and competitive imbalances and inequities that might flow through close association of the expanded activities with the resources and support, direct or indirect, of the federal safety net.

We believe the holding company format, supported by effective firewalls, would be an appropriate approach to adopt for thrift institutions.

Question 6: At the present time, thrift institutions which have concentrated in traditional home mortgages appear to be the healthiest segment of the industry. To a large extent this is due to the relative stability in interest rates over the past few years. In your opinion, what would the situation in the thrift industry be like if the high interest rates of the early 1980s had continued unabated until today? Are we gambling with the future by making assumptions as to the relative safety of a thrift institution activity based upon the particular economic climate of the present time?

Answer: In the early 1980s the vast majority of thrift institutions held a very high share of their portfolios in fixed-rate mortgages. Because these fixed-rate mortgages were funded almost entirely by retail deposits and other short-term liabilities, thrifts were extremely vulnerable to rising interest rates. Consequently, when interest rates rose to record levels in 1981, nearly 90 percent of the industry suffered operating losses. Between the end of 1980 and the end of 1982, these losses erased most of the aggregate tangible net worth of the industry, which fell from about $32 billion to about $4 billion. Had interest rates remained at peak levels, very few thrifts likely would have survived.

Since the early 1980s, the healthy segment of the thrift industry has significantly reduced its vulnerability to rising interest rates, largely by substituting adjustable-rate for fixed-rate mortgages. Nonetheless, the healthy segment of the industry remains quite vulnerable to rising rates. A rough rule of thumb is that under current balance sheet structure a one percentage point increase in interest rates would, in a year's time or so, reduce annual operating earnings of the solvent segment of the industry by about $2 billion. Thus, one must be very cautious in making inferences about the future prospects of thrifts that specialize in home mortgage lending. Absent further progress toward reducing interest rate risk, such traditional thrifts can operate safely only with substantially more capital than most of them have available at the present time.

Question 7: Under the Administration legislative proposal, what exactly is the capital standard that thrifts must satisfy by the 1991 deadline? Is it a flat 6 percent of assets? Is it the risk-adjusted ratio of 7.25 percent, which later goes up to 8 percent? Is it the higher of these two standards? There is significant confusion about this important question that needs to be cleared up.

Answer: The Administration's plan requires that thrift institutions meet bank capital standards by June 1, 1991. Currently, banks are subject to minimum leverage ratios of 5.5 percent primary capital-to-total assets and 6 percent total capital-to-total assets. Beginning at the end of 1990, banks will be subject to a minimum risk-based ratio of 7.25 percent, increasing to 8.0 percent at the end of 1992.

The banking agencies have tentatively agreed to maintain some overall leverage constraint (i.e. a capital-to-total assets ratio) in conjunction with the risk-based standard. This is necessary because the risk-based standard, in assigning certain assets to the zero or low credit risk categories, does not by itself place an absolute or sufficient limit on total leveraging. In retaining a leverage constraint, the banking agencies intend to bring the definition of capital for leverage purposes into line with the definition of capital for risk-based capital purposes in order to avoid confusion and minimize recordkeeping burden. Since the definition of capital for leverage purposes will change, the modified leverage benchmark ratio may not be set at the same 5.5 and 6.0 numeric levels as exist under the current bank capital guidelines. Nonetheless, any modified leverage benchmark would be set at a level that is essentially equivalent, or consistent, in terms of capital adequacy to the current bank capital standards.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM ROBERT L. CLARKE

1. You testified that "in 1863 Congress formally recognized [the OCC's] operating independence from the Treasury and Congress has thereafter reaffirmed it."

(a) Please explain in what ways the OCC is independent from the Treasury.

(b) Identify each statute that recognizes or reaffirms the OCC's operating independence.

Answer:

(a) Please explain in what ways the OCC is independent from the Treasury.

It has long been recognized that the OCC acts with some independence in such areas as bank mergers, charter applications, and branch applications.

With respect to broad policy initiatives and administrative matters, the OCC is affected more directly by its status as a bureau within the Treasury Department. The Department/Administration provide oversight over OCC policy initiatives. In practical terms, this oversight results, for example, in Treasury and OMB review and approval of OCC legislation, testimony, and responses to inquiries about pending legislation prior to their submission to Congress and of OCC regulations and notices of rulemaking prior to their publication in the Federal Register. In addition, the Department has exercised general oversight over OCC's management of its operations. Furthermore, as a bureau of the Treasury, the OCC is guided by the statutory interpretations of the Department, including the Department's General Counsel.

(b) Identify each statute that recognizes or reaffirms the OCC's operating independence.

The statutes set forth below each recognize or reaffirm OCC's operating independence. A full picture of the OCC's status vis-a-vis the Treasury Department, however, requires mention also of 12 U.S.C. § 1. That section provides that the Comptroller performs "his duties under the general directions of the Secretary of the Treasury." Moreover, in some instances, Treasury has determined that other legislation of general applicability has modified statutes specifically applicable to the OCC.

12 U.S.C. § 2 states that the Comptroller's term lasts five years; it is not concurrent with that of either the President or the Secretary. Only the President may remove the Comptroller during the term, upon reasons communicated to the Senate.

12 U.S.C. § 13 provides the OCC procurement authority.

12 U.S.C. §§ 481 and 482 give the Comptroller the authority to assess banks for expenses and to compensate employees with these funds without regard to other laws applicable to federal employees. Section 481 also makes it clear that these assessments are not appropriated monies. A recent amendment, enacted as part of Competitive Equality in Banking Act, provided that these monies are not subject to apportionment.

31 U.S.C. § 321(c) provides expressly that the "duties and powers" of the Comptroller are not vested in the Secretary of the Treasury. Duties and powers of all other officers and employees of the Department [with the exception of Administrative Law Judges] are vested in the Secretary. (This provision is the codification of Reorganization Plan No. 26 passed in 1950 and referred to in the Comptroller's testimony.)

5 U.S.C. § 5373 specifically exempts OCC employee compensation that is set by administrative action from a ceiling placed by Congress on pay fixed by administrative action.

2 U.S.C. § 905(g) provides that the OCC is exempt from sequestration under the Balanced Budget and Emergency Deficit Control Act of 1985, also known as "Gramm-Rudman-Hollings".

2. Are there any OCC personnel who in practice report to Treasury personnel rather than to you or your subordinates?

Answer:

The Comptroller of the Currency reports to the Secretary of the Treasury through the Deputy Secretary. In practice this relationship has not affected OCC's independence with respect to its quasi-judicial functions. However, the Secretary's general supervisory authority over the OCC gives the Department a role in administration and management of OCC's operations.

In addition, OCC's Chief Counsel, just as all other Treasury bureau counsel, reports to Treasury's General Counsel, who is the chief law officer for all elements of the Treasury Department. This relationship is based on statute and a 1938 Departmental Circular that transferred operating control of, and responsibility for, the legal work of the OCC to the General Counsel, and conforms with Treasury practice to have legal staff in all of its offices and bureaus operate as a part of a Departmentwide legal division headed by the Treasury General Counsel. This arrangement is intended to ensure that all Treasury attorneys have the independence necessary to exercise sound professional judgment in interpreting the laws relating to the authorities and responsibilities of their clients, i.e., the Treasury bureaus.

In practice, the reporting relationship to Treasury's General Counsel also has resulted in a role for the General Counsel in OCC's litigation activities. The General Counsel has been involved in decisions whether OCC should seek appellate review of court decisions and has assisted OCC in seeking Justice Department support for OCC positions in litigation.

3. **Is it desirable for a regulator of federally insured depository institutions to act as an advocate for and promoter of those institutions?**

Answer: No. It is not desirable for a regulator of federally insured depository institutions to serve simultaneously as a supervisor and as a promoter of regulated institutions; this situation is likely to present the supervisor with a difficult dual role. It is, however, appropriate for a regulator to be an advocate for measures that enhance the ability of federally insured institutions to compete in the market for financial services, since competition tends to promote the interests of the consumers as well as the safety and soundness of the banking system.

Acting as a promoter for regulated institutions can cause problems because, first and foremost, a regulator must be concerned about safety and soundness. The role of promoting regulated institutions can easily result in excessive regulatory forbearance, in an effort to keep insolvent institutions open. In the long run of course, keeping insolvent or nonviable institutions open can jeopardize the insurance fund that backs the industry's deposits.

The Administration's bill, S. 413, addresses this problem by requiring that any promotional action be consistent with principles of safety and soundness. In addition, by reorganizing the composition of the Boards of Directors of the District Federal Home Loan Banks and by clarifying the lines of accountability for supervision of federally insured thrifts, S. 413 takes important steps to correct institutional conflicts of interest that made the dual role of promoter and regulator/supervisor even more difficult.

4. Please describe the capital standards currently applicable to national banks. What level of capital is required? What qualifies as capital?

Answer: Current capital standards for national banks are defined in 12 CFR Part 3 (attached). These regulations require that primary capital be at least 5.5 percent of adjusted total assets and total capital be at least 6 percent of adjusted total assets.

Basically, primary capital is the sum of common stock, preferred stock, capital surplus, undivided profits, and allowances for loan and lease losses. A number of other items may count as primary capital, but, for the majority of banks, they are only a small portion of primary capital. These other items include reserves for contingencies (excluding accrued dividends on preferred stock), net worth certificates issued pursuant to 12 U.S.C. § 1823, minority interests in consolidated subsidiaries, purchased mortgage servicing rights, and mandatory convertible debt (within limits specified by regulation).

Total capital is the sum of primary capital and secondary capital. Secondary capital is defined as mandatory convertible debt not included in primary capital, limited life preferred stock, and subordinated notes and debentures. Secondary capital may not exceed 50 percent of primary capital.

5. Will the current capital standards continue to apply once the new risk-based capital standards take effect? If so, do you anticipate making any modifications in the current standards?

Answer: The three federal banking agencies recently issued the new risk-based capital guidelines, which will become effective at the end of calendar years 1990 and 1992. Until those risk-based capital standards go into effect, banks must continue to meet the minimum primary and total capital standards described in the answer to Question 4. Once the risk-based capital guidelines go into effect, we believe that a minimum capital-to-assets (leverage) ratio will be needed to protect against risks that are not explicitly addressed by the new capital guidelines and to limit the ability of banks to leverage capital by accumulating a large volume of assets in the lower risk-weighted categories.

Accordingly, the OCC expects to amend its current capital-to-assets requirement by December 31, 1990, to make it better suited for use in conjunction with the risk-based capital guidelines. First, instead of using the concepts of primary and secondary capital to measure capital adequacy, we plan to use the newly developed definition for Tier 1 capital found in the risk-based capital guidelines. It should be noted that the definition of Tier 1 capital is significantly more restrictive than the current definition of primary capital. Cumulative perpetual preferred stock, net worth certificates, the allowance for loan and lease losses, and mandatory convertible debt now are included in the definition of primary capital but are not included in the calculation of Tier 1 capital.

Second, using the definition of Tier 1 capital, we anticipate changing the minimum capital ratio to 3 percent. This is because the Tier 1 definition of capital is more restrictive than the definition of capital we now have, and we want to promote the incentives created by the risk-based requirement for banks to hold less risky assets. It is our intention to focus primarily on the risk-based capital ratio in our evaluations of capital adequacy. The leverage ratio should serve only as a "backstop" for those banks who could meet the risk-based capital requirement but have Tier 1 capital that is less than 3 percent of total assets.

6. Concern has been expressed that if a thrift institution were unable to meet applicable capital standards by June 1, 1991, the Administration's proposal would require that institution be sold or liquidated.

   (a) Is that true?

   (b) What consequences would a solvent institution face if it were unable to meet applicable capital standards?

   (c) Was there any interagency agreement on this point during the discussions in which the Administration's proposal was developed?

Answer: As proposed, S. 413 (FIRREA) does not require the sale or liquidation of a thrift that fails to meet the applicable capital standards on June 1, 1991.

Such an institution would, however, face restrictions on asset growth. Section 314 of FIRREA states explicitly that the Chairman of the FHLBS may, until June 1, 1991, restrict the asset growth of savings associations not in compliance with the applicable capital standards. After that date, asset growth by such associations would be prohibited.

The Administration bill is the result of exchanges of the views held by the federal regulatory agencies, and, as such, reflects interagency agreement on this point.

7. Concern has been expressed (a) that stronger capital standards could cause many marginally healthy thrift institutions to fail, and (b) that these additional failures would increase the cost of dealing with FSLIC's problems. What is your response?

Answer: Higher capital requirements, in and of themselves, are not going to cause more thrifts to fail. Failure occurs when a thrift's losses exceed its capital. Under the Administration's bill, solvent thrifts that fail to meet the minimum capital standard would not be able to grow, but they would not be closed.

Restricting the growth of undercapitalized institutions will provide a measure of protection for the deposit insurer. When undercapitalized institutions attempt to increase earnings, and thereby add to capital, through growth, they frequently expose the insurer to undue risks. Because little of their own capital is at stake, those institutions have an incentive to take on investments that are more risky than those well-capitalized institutions would undertake. Growth restrictions would reduce the ability of undercapitalized thrifts to take on risky investment.

Undercapitalized institutions can meet higher capital requirements by means other than adding to capital by retaining earnings generated through growth. For example, they might reduce assets or raise new capital. If, in the end, an institution is not successful in meeting the higher capital standards, it will not necessarily be liquidated, and it is by no means automatic that the insurer will lose money. The insurer will lose money only if the market value of the noncomplying thrift's liabilities exceed the market value of its assets.

8. Concern has been expressed that the FDIC's authority to increase insurance premiums to 35 cents per $100 of insured deposits would discourage investment in banks and thrift institutions.

   (a) What is your response?

   (b) Is that authority really needed? If so, why?

Answer: Since a part of the deposit insurance premiums paid by a bank or thrift institution is borne by the institution's owners in the form of lower operating profits, an increase in insurance premiums does reduce profits at banks and thrifts. This tends to reduce the value of bank and thrift stocks, and probably reduces the attractiveness of those stocks to investors.

Deposit insurance premiums, by design, compensate the FDIC for the risks that it assumes--risks that, in the absence of deposit insurance, would be borne directly by stockholders and creditors of banks and thrifts. The cost of bearing those risks is a real cost of doing business for those institutions. If the FDIC provides deposit insurance at a cost that is less than the cost of providing coverage, in effect it is subsidizing the operations of some depository institutions, and thereby subsidizing the returns to investors in those institutions. Such a subsidy would attract more capital to the banking and thrift industries than would otherwise be invested, and would be an unwise policy. When, instead, the FDIC charges actuarially fair insurance premiums, the result is that investors earn a return that accurately reflects the riskiness of their investment, and counter-productive incentives are avoided.

Changes in the insurance rates are reviewed by the FDIC Board of Directors, of which the Comptroller of the Currency is a member. I believe that it is extremely unlikely that conditions would deteriorate so much as to necessitate increasing insurance premiums to 35 basis points. But, if an emergency arose that justified such an increase in premiums, I believe the FDIC should have the power to impose them.

9. Under the Administration's proposal, the FDIC's Board of Directors would be expanded from three members to five, and the Chairman of the Federal Home Loan Bank System as well as the Comptroller of the Currency would be members _ex officio_. On February 12, 1989, the _New York Times_ reported that the Federal Reserve Board had sought to have its Vice Chairman included on the FDIC board, but that its request had been rejected.

   (a) Did the Federal Reserve Board seek representation on the FDIC board?

   (b) In the discussion during which the Administration's proposal was developed, did you express any opinion on whether the Federal Reserve should have such representation? If so, what views did you express?

Answer:

The concept of Federal Reserve Board representation on the Board of Directors of the FDIC was raised in early discussions among the staffs of the various agencies. The idea was never fully developed, however, and was never submitted to the principals for formal consideration.

10. Should Section 23A of the Federal Reserve Act be made applicable to transactions between banks and their subsidiaries?

Answer: The OCC permits national banks to own "operating" subsidiaries, which are treated as departments of the bank for purposes of federal law. Those subsidiaries are permitted to conduct only activities that are now permissible for the bank. Therefore, I do not favor applying the restrictions on inter-affiliate transactions of Section 23A of the Federal Reserve Act to transactions between banks and their "operating" subsidiaries.

If, however, Congress were to permit banks to conduct, within "insulated" subsidiaries, activities not now permitted to them under federal law, I would favor treating those subsidiaries as "affiliates" for purposes of federal law. Such treatment would thereby subject transactions between a bank and an "insulated" subsidiary to the restrictions of Section 23A.

11. We have heard that some states have done a poor job of preventing unscrupulous or otherwise unqualified persons from obtaining control of federally insured banks and thrift institutions -- and then engaging in fraud or other insider abuse that has been costly for the deposit insurance funds. Do you believe that the Federal change-in-control statutes need to be strengthened?

Answer: The Change in Bank Control Act ("CBCA") enables federal banking agencies to prevent the takeover of federally insured banks by persons whose lack of experience, integrity or financial ability renders them unqualified. The CBCA also deters unqualified individuals from even attempting to gain control of federally insured banks because they would have to submit themselves to the scrutiny that a CBCA notice involves. We believe that the CBCA has been effective in fulfilling its purpose.

There are, nevertheless, a few changes to the CBCA which would clarify its meaning or support its implementation. The following changes would be helpful:

- Broaden the coverage of the CBCA to include uninsured national banks, such as some trust companies and credit card banks. The CBCA now allows any person to obtain control of an uninsured national bank without regulatory review.

- Provide express authority to the agencies to impose enforceable conditions on the person desiring to acquire the bank and on the bank, for example, requiring the acquirer to contribute more capital than proposed. This would provide the OCC with the flexibility to permit certain changes in control to proceed on a safe and sound basis, and would not subject the proposed acquirer to the onus of a denial.

- Authorize the agencies to extend the period for disapproval for two 45-day periods if they have been unable to complete the investigation of a person desiring to acquire a bank because of delays in receiving information from third parties. This would give the agencies time to gather information without shortchanging their investigation. The CBCA now allows extensions if the agencies are unable to complete their investigation because of delays caused by the person who filed the notice.

- Delete the provision that a court may set aside an agency finding if the agency has violated the procedures of the CBCA. This would make the Administrative Procedure Act's standard regarding court review of agency action apply to CBCA cases. Thus, the reviewing court would be able to set aside a decision for substantial or prejudicial error, not merely harmless error. (This provision is included in S. 413.)

- Provide the authority for agencies to impose civil money penalties upon violations of the

CBCA that are not willful. The CBCA now requires that a violation be "willful" before a civil money penalty may be imposed. Since it is often difficult to prove that a violation was "willful," this change would enhance our ability to prosecute violations and increase compliance with the provisions of the CBCA. (This provision is included in S. 413.)

- Authorize the agencies to bring civil money penalty actions for violations of the CBCA pursuant to the Administrative Procedure Act, rather than the current de novo district court review. This would be consistent with the agencies' civil money penalty authority for all other violations of law. (This provision is included in S. 413.)

12. The enforcement provisions of the Administration's proposal have been criticized as "overkill" and "unnecessary." What is your response? Why are those provisions justified?

Answer: The enforcement provisions contained in the Administration's proposal are reasonable and necessary to ensure that the agencies have the tools they need to address the problems in the industry. Several of the provisions serve to clarify administrative authorities that have been important to agencies' enforcement efforts, but which have been called into doubt by recent court decisions. Examples of this include the authority to seek reimbursement from directors for losses resulting from activities they have approved that violate the law. This authority had previously been upheld by a U.S. Court of Appeals, but was called into question by a subsequent decision by a different Court of Appeals.

The agencies have also long exercised the authority to remove individuals from banking for misconduct and illegal transactions which occurred while the individual was in a bank -- even though the individual may have resigned or been fired prior to the issuance of a Notice of Intention to Remove by the agencies. This authority was also called into question by a recent Court of Appeals decision.

Other amendments to the agencies' enforcement powers address weaknesses in current law. The bill, for instance, closes the loophole in current law which does not allow the assessment of civil money penalties against bank insiders in situations involving unsafe or unsound practices or breaches of fiduciary duty that do not constitute specific violations of banking laws but which result in pecuniary gain to the individual or loss to the institution. The lack of authority to seek civil money penalties in these circumstances restricts the ability of the Federal banking agencies to take appropriate, timely and effective enforcement action against bank insiders who have abused the bank. In addition, it underscores an inconsistency in the current statutes. The statutes permit the Federal banking agencies to respond to egregious statutory violations by bank insiders with both a removal action and a civil money penalty action, but allow for only a removal action to be initiated against bank insiders who have committed equally egregious unsafe or unsound practices or breaches of fiduciary duty when they do not violate specific banking statutes.

While removal actions can be very effective in neutralizing those who may abuse a national bank for personal gain, and may serve to deter others from engaging in similar activity, such actions may not always sufficiently penalize the responsible individuals. In such cases, the individuals involved should not be immune from civil money penalties merely because their conduct, while very damaging, did not violate a specific banking statute.

This additional civil money penalty authority and other administrative remedies in the bill provide sufficient due process, including hearings and appeals under the Administrative Procedures Act, in the same manner as administrative actions authorized under current law.

In addition, the Administration has proposed to increase the amount of civil money penalties which the agencies can assess. Increased penalties are warranted if they will serve as a further deterrent to fraud and misconduct and will provide the agencies with additional flexibility in dealing with serious cases of fraud and abuse.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
ROBERT L. CLARKE

1. I am concerned about the zeal to put thrifts under bank accounting practices, with no deviations. I am not saying that thrifts should get off more leniently. I am only saying that certain characteristics of thrifts require regulations that are tailored to what thrifts do--at least the traditional ones--which is make mortgage loans. The Bank Board recently proposed a tough risk-based capital standard that takes into account interest rate risks, which the banks' regulation does not do. Interest-rate risk is a particular problem in the thrift industry, as you know. Will the new plan ignore this and other similar innovations? I have heard talk about imposing the more restrictive of the two sets of rules in any situation, but that may be too severe. What is your view?

Answer: The work the FHLBB has done on risk-based capital standards will not be ignored. First, the FHLBB's risk-based capital proposal borrows heavily from the guidelines that have been adopted by the federal bank regulators. To the extent that thrift and bank regulations are similar, there will be no need to change them. Second, we recognize that the FHLBB has made important innovations in setting capital requirements for interest rate risk. We think this work will be very helpful to the three federal bank regulators as they study ways to incorporate an interest rate risk component into their risk-based capital requirements.

With regard to the question of making thrift capital standards more consistent with the ones that apply to banks, I would point out that bank and thrift capital regulations are becoming more similar. In part, this is due to the recognition that many banks and thrifts are becoming more alike. I believe that thrifts and banks with similar portfolios should have similar capital requirements. If a thrift will have a different capital requirement under the FHLLB's proposal than a bank with the same portfolio risk, then I think it is appropriate to eliminate such differences.

Similarly, we should not be placing thrifts at a disadvantage to banks. Therefore, I do not advocate imposing on thrifts the more restrictive of the two sets of capital rules, which, by implication, suggests that a bank would be allowed to maintain a lower minimum capital requirement than a thrift.

2. Chairman Riegle and I led a fight during the CEBA legislation to exempt the bank and thrift regulators from Gramm-Rudman and OMB apportionment. We won, but OMB fought us every step of the way. In the Administration plan, will any of the regulators become subject once again to either Gramm-Rudman or apportionment? I am very concerned that Bank Board and Comptroller regulators will be subject to federal pay and staffing restrictions, while the other bank regulators will not be restricted. How does the Administration plan to address this issue?

Answer:

Gramm-Rudman-Hollings and Apportionment

With respect to Gramm-Rudman-Hollings (the Balanced Budget and Emergency Deficit Act of 1985) and apportionment, the OCC will continue to be exempt from those statutory provisions under the Administration's bill. Twelve U.S.C. § 481 provides that assessments are not considered to be appropriated monies or government funds. Provisions in the Competitive Equality in Banking Act (CEBA) provided that these assessments are not subject to apportionment, and that the OCC is exempt from Gramm-Rudman. Nothing in the Administration's plan alters these statutory provisions. The Administration's bill would treat the FHLBS in the same manner.

Staffing and Compensation

Under 12 U.S.C. § 481, the Comptroller is authorized to employ personnel with the approval of the Secretary. The Administration's bill leaves this unchanged. (Similar language is proposed to apply to the FHLBS.)

With respect to compensation, the Administration's bill provides in § 1103 that, subject to approval of the Secretary of the Treasury, the Comptroller may fix the compensation of OCC employees, "without regard to the provisions of any law or regulation (including, but not limited to, provisions of title 5 of the United States Code) relating to Federal employee and officer compensation." Section 1103 thus makes clear that OCC employee compensation is not limited by pay limitations applicable to other Federal employees or by any other provisions of law, and directs that in setting and adjusting compensation the Comptroller shall seek to maintain comparability with compensation at the Federal Reserve Board, the FDIC, and the FHLBS. (Similar provisions are included in section 702(e) of the Administration's bill with respect to the FHLBS.)

The compensation authorities of the other bank regulators are similar in scope to those proposed by the Administration for the OCC and the FHLBS. The Federal Reserve Board and the FDIC, however, exercise their staffing and compensation authorities without additional oversight.

3. Many have criticized certain accounting practices of thrifts, especially the practice of lending the full amount of principal, several years of interest, and certain loan fees in connection with real estate development deals. That permits a developer to use borrowed money to pay interest and loan fees before any revenue is generated by a development project. It also permits the S&L to book the return of the money just lent as "profit" that it can use to pay massive dividends to insiders. I have several questions: First, isn't it true that bank real estate loans are accounted for the same way? Second, should Congress put a stop to the practice for both thrifts and banks? Finally, should borrowers be required to guarantee repayment personally in addition to using the real estate collateral? Wouldn't that help curb speculative ventures while at the same time giving the institution and the insurance fund a better chance of recovery in the event of losses?

Answer: Basically, Generally Accepted Accounting Principles (GAAP) for real estate loans are the same for both banks and thrifts. Two important accounting standards recently promulgated by the AICPA and the FASB are discussed later in this response; both apply equally to banks and thrifts.

The OCC has very clear real estate accounting and supervisory guidelines that apply to national banks. Your question particularly focuses upon capitalization of interest income, which is covered by our Examining Circular 229; this circular is also reviewed in greater detail below. However, we are not in a position to comment upon details of the regulatory or supervisory treatment of real estate lending practices as they apply to thrift institutions.

Ultimately the wisdom of extending real estate development loans comes down to a matter of credit judgment that must be exercised case-by-case. Legislating personal guarantees for real estate development loans would be an attempt to legislate credit judgment which, I believe, is not practical. My reasons for this belief are presented in greater detail below.

Accounting for Real Estate Loans

The first question refers to the accounting treatment of real estate development loans. In particular, it focuses upon the practice of lending a developer the funds not only to buy the land, labor and raw materials to do the project, but also to pay interest on the loan. The practice of lending the borrower the money to pay the interest on the loan is broadly referred to as capitalization of interest. It is called capitalization of interest because interest income is recognized and "capitalized" in the form of an asset on the lender's books, even though the lender has not received cash payments from the borrower. This is an accepted project financing technique for real estate development, and other investment projects, when the assets being financed are not expected to generate income until the project is completed. However, capitalization of interest is potentially subject to abuse by lenders, and for this reason the practice has been the subject of attention by both the accounting profession, and by the OCC in its supervision of national banks.

AICPA Guidelines on ADC Lending. The type of real estate lending you describe is often referred to as real estate acquisition, development and construction (ADC) arrangements. In February 1986, the American Institute of Certified Public Accountants (AICPA) issued its Notice to Practitioners--ADC Arrangements, to guide the accounting for ADC arrangements of financial institutions, including both banks and thrifts. This notice points out that in some ADC arrangements a financial institution may have virtually the same risks and potential rewards as a real estate owner or joint venturer. In such cases, the notice provides criteria for determining whether the ADC arrangements should be accounted for as a real estate investment, loan, or joint venture.

Recognition of Interest Income. With regard to the recognition of income on real estate investments and joint ventures, the AICPA Notice states that a financial institution may not recognize income by merely advancing funds to the ADC arrangement.

The recognition of interest income on loans by national banks when cash payment is not received is subject to OCC Examining Circular No. 229, Guidelines for Capitalization of Interest on Loans (EC 229) issued in May 1985. EC 229 states that capitalization of interest "is appropriate only when the borrower has the ability to repay the debt in the normal course of business." The borrower's ability to repay should be "based primarily upon the credit worthiness of the borrower."

EC 229 gives specific questions that bank management and examiners must consider in deciding whether it is appropriate to recognize interest income when cash payment is not received. These questions focus attention on all factors of the lending process, but predominantly on the likelihood of ultimate repayment. Among these is the question of whether the loan is well-secured by the guarantee of a financially responsible party.

Thus, both accounting policy and OCC supervisory guidelines prohibit national banks from recognizing "the return of the money just lent as 'profit'", unless the facts and circumstances warrant doing so.

Treatment of Loan Fees. With respect to accounting for loan fees, in December 1986 the Financial Accounting Standards Board (FASB) issued Statement of Accounting Standards No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (FAS 91). FAS 91 applies to all transactions entered into during fiscal years beginning after December 15, 1987 (in essence from the first quarter of 1988 forward).

The most significant change under FAS 91 is the requirement to defer nearly all loan fees (as well as costs) over the life of the loan, as an adjustment to the loan's yield. Previously, loan fees were to be accounted for based on the "substance" of the lending transaction. In practice this resulted in most fees being recognized as income immediately.

What many viewed as a discretionary accounting practice by both banks and thrifts has now been rectified by FAS 91. Accordingly, the ability of both banks and thrifts to recognize loan fees as income "up-front" (whether paid in cash or borrowed by the borrower) has been severely limited.

Legislative Action on Capitalization of Interest

The second question asks whether Congress should "put a stop to the practice [of capitalization of interest] for both banks and thrifts." Given the public accounting standards published by the AICPA and the FASB, and the examination guidelines regarding capitalization of interest in EC 229, we do not believe that legislation to stop capitalization of interest is either necessary or appropriate. Capitalization of interest in the context of ADC lending is not an unsound practice if banks and thrifts engaging in it are adhering to prudent credit standards and sound lending policies. The OCC requires any national bank to have sound lending policies in place if it intends to engage in ADC lending. The OCC regularly reviews and tests adherence to these policies and requires corrective action if potential problems are disclosed.

Personal Guarantees of ADC Loans

The third question asks whether borrowers should be required to personally guarantee ADC loans. We do not believe that a general requirement for personal guarantees would be an optimal way to reduce the risks of making such loans. Some real estate developers are not well-capitalized, so personal guarantees would not add much comfort to the lender. In other cases, prudent lending may call for personal guarantees. Regardless of whether the banker calls for personal guarantees, they would form only one facet of the overall credit decision. Ultimately, commercial viability of the project and the developer's ability to execute the project are the best criteria upon which to extend real estate development loans.

Thus, the wisdom of extending real estate development loans comes down to a matter of credit judgment that is exercised case-by-case. Bankers should be permitted to make their own credit decisions based on their review of credit and collateral factors.

Finally, requiring by law that developers sign personal guarantees would be a substantial departure from the normal practice related to corporate indebtedness. In other sectors of the economy, individuals and firms are generally allowed to divide their holdings among distinct corporations, none of which is liable for the obligations of the rest. This ability to insulate the profits earned by one holding from losses sustained by others is beneficial, on balance, to the efficient operation of capital markets. I see no reason why real estate developments should be treated differently from other types of ventures in this respect.

4. Many have spoken frequently of the "moral hazard" that occurs when a federally-insured depository institution's capital has been substantially depleted. The managers of such an institution have an incentive to make risky investments because they no longer have a substantial amount of capital that they would lose if the investments went sour. Isn't the same "moral hazard" present when an institution's market value capital drops substantially, even if its GAAP capital does not? If so, should the Congress require depository institutions to begin some form of market value reporting?

Answer: The OCC agrees that a moral hazard problem arises when the market value of a bank's capital has declined to such an extent that its owners have little at stake. The difficulty in using market value accounting to decide when an institution should be closed lies in measuring the market value of assets and liabilities. In order to do so, it is necessary to value each asset in the institution's portfolio. The measurement must also be accurate enough to stand up to legal challenge, since closing a bank while some equity actually remained could constitute an unlawful taking of property.

While market valuation of assets may be feasible for securities that are traded in established markets, it is far more difficult for commercial loans. Despite progress in recent years to develop markets for securitized receivables, such as credit card loans and automobile loans, secondary markets are not well-established for the vast majority of commercial and industrial loans that still comprise a large portion of banks' lending business. Valuing loans to small businesses is particularly difficult. It requires specialized information about the creditworthiness of the borrower which cannot easily be communicated to secondary market participants.

The OCC has a strong interest in exploring methods to measure the market value of commercial loans and other bank assets. Our Bank Accounting Division is following closely the work of the FASB Financial Instruments Task Force, which is investigating the accounting standards to be used to measure and disclose the value of financial instruments. Because the financial statements of banks are made up principally of financial instruments, this Task Force is also looking into how market value accounting standards could be more widely applied in financial institutions. However, it would be premature for Congress to require market value reporting until there is greater consensus among both the users and preparers of financial statements as to the practicality of implementing market value accounting standards.

5. Under the Administration legislative proposal, what exactly is the capital standard that thrifts must satisfy by the 1991 deadline? Is it a flat 6 percent of assets? Is it the risk-adjusted ratio of 7.25 percent, which later goes up to 8 percent? Is it the higher of these two standards? There is significant confusion about this important question that needs to be cleared up.

Answer: As you know, under the Administration's plan, thrifts will have to meet capital standards at least as stringent as bank capital standards by June, 1991. However, in June 1991, bank capital standards will be in transition.

Risk-based capital standards for commercial banks will be fully implemented on December 31, 1992. At full implementation, banks will have a minimum capital requirement of 8 percent of risk-weighted assets, with capital defined as equity capital plus other approved components. During the transition period, banks will be required to have capital equal to at least 7.25 percent of risk-weighted assets. There are also transition treatments of supplementary capital, goodwill, and the allowance for loan and lease losses.

In addition to the new risk-based capital requirement, the existing capital regulations remain in effect until December 31, 1990, to serve as a floor for the level of capital that banks must meet regardless of their risk-weighted asset requirements. This is the so-called tandem leverage ratio. The OCC stated its intent to revise this current capital requirement, 12 CFR Part 3, when it issued its risk-based capital guidelines. The OCC intends to have these revisions in place by December 31, 1990. If there is no amendment by that date, then both the current capital requirements and the risk-based capital requirements would be applicable.

Our proposal to amend 12 CFR Part 3 would change this minimum tandem ratio and define capital in a way that would be consistent with the measurement used in the risk-based capital standard. The OCC believes that a requirement of 3 percent core capital to total assets is appropriate. This leverage requirement is designed to eliminate the possibility of excessive leverage through a concentration of assets in low-risk weight categories. The OCC believes that the combination of risk-based capital and the tandem leverage requirement should produce a level of capital that adequately protects the deposit insurance fund against losses.

6. With respect to your views on the need to separate the regulator from the insurer, I note that with respect to state nonmember banks, the FDIC plays both roles. While these institutions are chartered by the states, the FDIC is the primary federal regulator, setting capital and other prudential standards. According to your testimony, there should be an internal conflict between the FDIC's role as regulator in trying to promote new powers and products and its role as insurer. Is there any evidence that such a conflict exists? Is the FDIC's regulatory role with respect to these institutions in any way less stringent than the regulatory role imposed by the OCC or Federal Reserve Board? If not, does this indicate that the existing FDIC model as both regulator and insurer over state nonmember banks is [an] acceptable regulatory structure?

Answer: We have no evidence the FDIC is less stringent in its regulation and supervision of state-chartered nonmember banks than the OCC or the Federal Reserve are vis-a-vis national banks and state member banks respectively.

In our testimony, we argued that combining the deposit insurance function with bank regulation and supervision would tend to lead to overly conservative supervision as long as the deposit insurance fund is solvent. Because the insurer is charged with protecting the deposit insurance fund, we believe the insurer would naturally tend to be a very cautious bank regulator and supervisor. Within limits, caution is a worthy trait for a bank regulator; too much caution, however, runs the risk of stifling innovation and necessary change in the banking system. I believe the OCC has been prudently cautious in its oversight of national banks. Indeed, a study by the FDIC has shown that the cost the FDIC has borne from failed national banks, on average, is virtually the same as, and in the aggregate lower than, the cost it has incurred from failed state banks, which it oversees; this evidence suggests that, measured by the cost of bank failure, the results of our supervision has been about the same as the FDIC's.

Nevertheless, we believe that there are instances where, in an attempt to minimize risk to the fund, the FDIC would impose more expensive regulation on banks than we believe is appropriate.

Risk-based capital is one issue where the FDIC has demonstrated a very cautious approach. The final risk-based capital guidelines recently published by the three federal banking agencies contain a proposal to keep a minimum leverage ratio, of capital relative to total assets. This ratio is sometimes referred to as a "tandem" leverage ratio, because it would apply in tandem with the new risk-based capital standards. All three agencies believe that a tandem ratio is necessary to provide adequate protection against certain risks (such as interest rate risk) that are not explicitly addressed by the risk-based capital guidelines, and to serve as a restraint against banks leveraging themselves to very high levels with assets that require no capital. For the purpose of setting the tandem ratio, the OCC's proposal would define capital in a way that would be consistent with the measurement used in the risk-based capital standard. As a minimum standard for the tandem ratio, the OCC believes that a requirement of 3 percent core capital to total assets is appropriate; combined with the risk-based capital requirements, a 3 percent tandem leverage ratio should produce a level of capital that adequately protects banks against losses.

The FDIC has expressed a more cautious philosophy on this issue, arguing that the tandem leverage ratio should be the same as the existing provisions, which would be 6 percent of total assets. If implemented, the FDIC's proposed tandem ratio would likely become the operative capital standard for most banks, in effect undermining the entire risk-based capital approach that we have worked more than two years to put in place. Because the new risk-based capital standards explicitly tie a bank's capital requirement to the riskiness of its assets, they serve well to replace the existing capital standard and permit us to specify a new tandem leverage ratio of 3 percent.

Another example of the FDIC's very cautious approach lies in its proposed asset growth rule. The FDIC's proposed rule would require a series of reports to the FDIC if a bank's growth plans exceeded a predetermined level or if actual growth exceeded certain thresholds. In our view, such a reporting requirement would be unnecessarily burdensome for national banks. The information the FDIC seeks is readily available to OCC examiners and could be efficiently shared with the FDIC through the existing supervisory framework, rather than through the introduction of a detailed regulation.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM L. WILLIAM SEIDMAN

Q.1. The Administration has proposed to give the FDIC limited authority over capital and accounting standards for federally insured thrift institutions. If Congress were to strengthen that authority -- in the interest of protecting the deposit insurance fund -- would you object?

A.1. If Congress were to strengthen the authority the FDIC is to have over the establishment of capital and accounting standards for federally insured S&Ls, the FDIC's ability to manage and control the risks to its insurance fund would be enhanced. With such authority, the FDIC would be better able to ensure that the accounting and capital standards which are established and maintained are as uniform as possible for both banks and thrifts. Therefore, the FDIC would not object if Congress were to conclude that FDIC's authority over thrift accounting and capital standards should be strengthened. The FDIC would be willing to work with Congress in drafting the necessary language for such authority.

Q.2. Under the Administration's proposal, the FDIC would have certain authority to prohibit or restrict the exercise of state-authorized powers by federally insured thrift institutions. Would that authority really be any broader than the authority currently possessed by FSLIC? If so, in what way?

A.2. Section 218(5) of the Administration's proposal would amend section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828) to provide the FDIC with the authority to adopt regulations, after consultation with the Chairman of the Federal Home Loan Bank System, applicable to federally insured state-chartered thrift institutions specifying that certain activities pose a serious threat to the Savings Association Insurance Fund. Furthermore, the FDIC may prohibit a federally insured state thrift from directly engaging in any such activity that is not permissible for a federal savings and loan association under the Home Owners' Loan Act.

The United States Court of Appeals for the District of Columbia determined that the Federal Home Loan Bank Board has the authority to adopt regulations designed to protect the integrity of the insurance fund. Therefore, the Bank Board's direct investment rule, which sought to limit the risks posed to insured thrifts -- state as well as federally chartered -- by high-risk investments, was held to be consistent with that agency's authority. Lincoln Savings and Loan v. Federal Home Loan Bank Board. 856 F.2 1558 (D.C.Cir. 1988). Presumably the Bank Board can prohibit activities that are determined to pose a serious threat to the insurance fund as well as restrict such activities.

The explicit authority granted to the FDIC by the Administration's proposal thus would not appear to be any broader than that presently enjoyed by the Bank Board, the one difference being that the Bank Board's authority to adopt such regulations is not express. The Bank Board's authority was found to derive from its general rulemaking authority under the National Housing Act to prescribe rules and regulations to carry out the purposes of that Act (12 U.S.C. 1725(a)) and its authority to issue orders directing insured thrifts to cease and desist from engaging in any unsafe or unsound practice and to adopt rules and regulations with respect to such practices. (12 U.S.C. 1730(e), 1730(m)(3)).

Q.3. In your testimony before the Committee, you described some firewall restrictions that could be imposed on transactions between a federally insured depository institution and its subsidiaries. The depository institution would, for example, be permitted to make investments in or loans to the subsidiary only out of "excess capital." Your testimony appeared to imply that such restrictions, properly enforced, would virtually eliminate any risk to the depository institution that might arise from the subsidiary's activities.

Comptroller Clarke later cited the FDIC's securities subsidiary regulation as a model of the types of firewall restrictions that, in his view, would make it safe to conduct virtually any activity through a subsidiary of a bank.

(a) Does the FDIC's securities subsidiary regulation require all of a nonmember insured bank's investments in and loans to a securities subsidiary to be made from excess capital?

(b) Does the regulation require a bank's investment in a securities subsidiary to be deducted from the bank's regulatory capital? What about the bank's loans to the securities subsidiary?

(c) Under the regulation, would it be possible for a bank to acquire a securities subsidiary -- or to greatly increase its investment in a securities subsidiary -- even if the bank were in violation of applicable capital standards?

(d) Are extensions of credit from the bank to, or for the benefit of, the securities subsidiary subject to restrictions at least as stringent as those applicable under section 23A of the Federal Reserve Act to transactions with affiliates?

(e) Has the FDIC required that nonmember insured banks conduct real-estate development activities only through a subsidiary or affiliate, subject to stringent firewall restrictions such as those you outlined to the Committee? If not, why not?

A.3. (a) Yes, as to investment; No, as to loans. Section 337.4(b)(3) of the FDIC's regulations (12 C.F.R. 337.4(b)(3)) provides that an insured nonmember bank's direct investment in certain securities subsidiaries will not be counted toward the bank's regulatory capital. In addition, section 325.5(d) (12 C.F.R. 325.5(d)) provides that any securities subsidiary subject to section 337.4 shall not be consolidated with its bank parent and any investment must be deducted from the bank parent's primary or secondary capital. The effect of the two provisions is that a bank's investment in (_i.e._, capital contribution to) a securities subsidiary covered by section 337.4 must be made from excess capital. Neither provision requires, however, that loans made by the bank parent to the securities subsidiary be made from excess capital.

(b) As indicated above, FDIC's regulations deduct a nonmember bank's capital investment in a securities subsidiary from the bank's regulatory capital. Loans made by the bank, however, are not deducted.

(c) Although the regulation does not specifically prohibit an insured nonmember bank from acquiring a securities subsidiary (or increasing its investment in an existing securities subsidiary) if doing so would reduce the bank's capital below applicable standards, a bank is effectively precluded from doing so. Insured nonmember banks are required to give the FDIC 60 days notice prior to the acquisition or establishment of a securities subsidiary. (12 C.F.R 337.4(d)) One of the things the FDIC reviews upon receipt of the notice is whether the bank will be adequately capitalized after the requisite deduction is made. If not, the FDIC will take appropriate action. The preamble to the final regulation contained the following:

> None of the notice requirements are an approval process although the FDIC will not be precluded from intervening in an intended acquisition or establishment of a subsidiary or from objecting to the expansion of activities if such intervention or objection is warranted, for example, if the subsidiary would not appear to meet the requirements for a bona fide subsidiary, or any details of the planned transaction (such as the source of funding for the establishment or acquisition of the subsidiary) present any supervisory concerns.

Similarly, although the regulation does not require that an insured nonmember bank give notice or obtain the FDIC's approval before increasing its direct investment in a securities subsidiary, if the bank's capital is below standards, the FDIC will take appropriate remedial action.

(d) The regulation provides that an insured nonmember bank may not make any loan or extension of credit to a subsidiary of the bank that (i) distributes or underwrites stocks, bonds, debentures, notes, or other securities, or (ii) advises any investment company, unless the loans or extensions of credit are in compliance with the restrictions imposed on transactions covered by section 23A of the Federal Reserve Act, including the limits as to amount. The regulation also limits or prohibits loans for a variety of other transactions where the customer may be a client of the subsidiary or the security may be one in which the subsidiary had a direct or indirect interest. (12 C.F.R 337.4(e)).

(e) At present, the FDIC does not have any regulations requiring that real estate development activities be conducted only through a subsidiary or affiliate. In 1984, the Board of Directors of the FDIC initiated a proposed rulemaking proceeding soliciting comment on a regulation governing the direct and indirect involvement of all insured banks in real estate brokerage and development, insurance brokerage and underwriting, data processing for third parties, travel agency activities, and other financially related services. (49 FR 48552, December 13, 1984). The proposal went through a number of changes and in its last form, published for comment on June 7, 1985 (50 FR 23964), would have required that real estate development activities be conducted in a subsidiary subject to firewall restrictions if those activities exceeded 50 percent of the bank's primary capital. An insured bank would have been permitted to engage directly in real estate development provided that the bank's capital met the regulatory requirements; the bank's aggregate investments in real estate development activities, including related extensions of credit, did not exceed 50 percent of the bank's primary capital; and the bank's aggregate investment in any one real estate development, including related extensions of credit, did not exceed 10 percent of the bank's primary capital.

On December 15, 1987 the Board of Directors withdrew the proposal, citing preliminary indications which showed that at the time there was insufficient evidence of any system wide problems in FDIC-insured banks resulting from newly-granted real estate investment powers that warranted the adoption of an across-the-board limitation. (52 FR 48448, December 22, 1987). The Board further indicated, however, that efforts to establish guidelines for the safe and sound conduct of real estate development activities by insured banks and their subsidiaries would continue. FDIC staff was directed to continue to study bank involvement in these activities and to develop a proposed regulatory approach, as appropriate, for the Board's consideration. In the interim, real estate development activities are being monitored and any supervisory problems are being dealt with on a case-by-case basis.

Staff is presently considering a proposed regulation that would require insured banks to provide the FDIC prior notice before exercising any "nontraditional" power or establishing or acquiring a subsidiary to do so. Information of this sort would allow the FDIC to identify institutions that need to be supervised more closely. A regulation addressing the conflicts of interest that arise when a bank insider is an equity participant in real estate development in which the bank and/or its subsidiary is involved also is being considered.

Q.4. You testified that you would not object to requiring federally insured thrift institutions to devote at least 70 percent of their assets to housing finance as long as they were free "to do other kinds of economic activities in subsidiaries or affiliates."

(a) What kind of activities did you have in mind?

(b) Do you have doubts about whether thrift institutions can be viable as residential mortgage lenders?

(c) Is there any kind of lawful economic activity that you would consider inappropriate for a subsidiary or affiliate of a federally insured depository institution?

A.4.(a) and (c) There is no obvious criterion by which to limit the activities conducted in separately capitalized subsidiaries of banks or thrifts. As described in the FDIC's 1987 study, Mandate for Change, we believe banks and thrifts can be effectively insulated from the risks in their subsidiaries and, via the same measures, the safety net can be effectively restricted to the banking entity alone. There may be some idiosyncracies in certain activities that make insulation more difficult, but the Mandate study's recommendations provide for phase-in schedules and experience-based learning that should eventually accommodate whatever activities are profitable for these institutions. In principle, there is no reason to draw ex ante boundaries for permissible activities in a subsidiary.

(b) Based on the success of many existing thrift institutions, there is little doubt that (under current conditions) thrifts can sustain a role in mortgage lending. However, the future size of the thrift industry, like any industry, is open to question. It depends upon the unknowable course of financial evolution, competition, and other market conditions. The banking and thrift industries should be allowed to seek their own levels, to the extent possible, through fair and free competition for the consumer's dollar. Interventions to preclude the verdict of the market in this case are likely to be unnecessarily costly and, ultimately, counterproductive.

Q.5. I believe that the activities of a federally insured state thrift institution should be limited to those permissible for a federal S&L. Would you object to Congress' adopting that approach?

A.5. The purpose of activity restrictions has been to assure that the activities undertaken do not pose an undue risk to the safety of depositor funds and to enforce some concept of a separation of banking and commerce. At the same time, it is important that thrifts be able to compete successfully in a changing and expanding financial marketplace. (See the previous question for our comments on powers in general.) In the banking arena, we have seen the successful operation of the so-called "dual banking system," wherein powers are sometimes initially defined at the federal level and sometimes at the state level. This dual system has served as both an option for change and a check on unilateral extremes. We believe that such a dual bank chartering and powers granting system has served us well and can work effectively in the thrift industry.

If the insurer is separate from the powers granting chartering agency, a further check on abuse is possible. The FDIC believes that it should be authorized to decide which authorized powers insured institutions can engage in directly, either across-the-board for all banks or in some instances on a case-by-case basis. We therefore suggest that Congress not adopt a requirement limiting state chartered thrifts to the powers of a federal thrift. Instead, there should be a focus on the powers of the insurer to control imprudent use of existing powers. We also suggest that before using Federal thrift powers as a standard we first compare them with bank powers on such matters as, for example, real estate lending limits.

Q.6. Should section 23A of the Federal Reserve Act be made applicable to extensions of credit by an insured bank to its subsidiaries?

A.6. It is important that banks have the ability to compete in today's fast-changing financial environment. At the same time the FDIC insurance fund must not be put at risk through speculative or unusually risky investments. These competing desires can, we believe, be accommodated by allowing banks to engage in nontraditional activities by placing such activities in separately capitalized subsidiaries with stringent firewalls. Section 23A type restrictions should clearly be made a part of the firewalls between a bank and its subsidiaries that are engaged in such nontraditional activities.

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Q.7. For each year from 1981 through 1988, please state the following for all FDIC-insured banks in Texas and then for all FSLIC-insured thrift institutions in Texas:

(a) total assets;

(b) the cost of dealing with failed or failing institutions (for each year, and for 1981-1988 in aggregate); and

(c) the estimated cost of resolving the remaining problems.

A.7. The following tables contain available data regarding FDIC-insured and FSLIC-insured institutions in Texas. Since 1981, 234 of the state's FDIC-insured banks have failed or required financial assistance to avert failure. Of the ten largest banking organizations in the state, six have in some way been merged, restructured and recapitalized. We have already set aside reserves for losses in three others. Thus, whatever problems still remain in Texas should be limited to much smaller institutions whose resolution costs would not pose a threat to the insurance fund. The failure rate in Texas is expected to decline significantly over the next year, resulting in substantially lower failure resolution costs going forward.

FDIC-INSURED INSTS. IN TEXAS ($ in millions)	1981	1982	1983	1984
TOTAL ASSETS	143,239	163,503	181,923	197,926
FAILURE RESOLUTION COST*	0	5.5	559.0	42.5

FDIC-INSURED INSTS. IN TEXAS ($ in millions)	1985	1986	1987	1988
TOTAL ASSETS	209,034	207,696	190,226	171,103
FAILURE RESOLUTION COST*	79.1	280.2	891.5	5,667.7

* Reserve data as of September 30, 1988. Failure resolution cost for 1988 represents 102 banks with $47.5 billion in assets.

Based on data provided by the FSLIC, the agency has taken over 109 Texas S&Ls between 1981 and 1988 with total assets of $46.35 billion. The aggregate cost of resolving these insolvencies over that period is reported to be $26.88 billion. As of March 17, 1989, another 54 Texas thrifts had been placed into a conservatorship. Because no final solution has been determined for these institutions, cost estimates are not available at this time.

FSLIC-INSURED INSTS. IN TEXAS ($ in millions)	1981	1982	1983	1984
TOTAL ASSETS	38,000	42,000	57,000	78.000
FAILURE RESOLUTION COST*	1.3	72.3	0	163.8
FDIC-INSURED INSTS. IN TEXAS ($ in millions)	**1985**	**1986**	**1987**	**1988**
TOTAL ASSETS	94,000	96,000	100,000	111,000
FAILURE RESOLUTION COST*	155.0	493.2	1,504.5	24,493.5

* Discounted present-value cost.

Q.8. Is it desirable for a regulator of federally insured depository institutions to act as an advocate for and promoter of those institutions?

A.8. We believe it is very undesirable for a regulator of federally insured depository institutions to act as an advocate for and promoter of those institutions. To act as such presents the regulator with a conflict of interest when the desires and narrow interests of a class of depository institutions and their trade associations conflict with safety and soundness concerns and the broad public interest. In our view, a regulator must first and foremost uphold the public interest at all times. Regulatory structures and incentives should be designed to encourage this result and minimize the influence of regulated depository institutions over their regulators. However this position must be carefully balanced with a keen awareness that a healthy, profitable financial system is in the public interest and minimizes risk to the insurance fund. There may therefore be occasions when the regulator must speak for those things which the industry needs to remain sound and competitive.

Q.9. Under section 408(m)(1)(A)(i) of the National Housing Act, the FSLIC may currently authorize any company to acquire a failed or failing FSLIC-insured thrift institution "[n]otwithstanding any provision of the laws or constitution of any State" or (with a few exceptions) "any provision of Federal law." FSLIC has given this provision a broad interpretation that has been a source of considerable controversy and concern.

Under the Administration's proposal, section 408(m) would be transferred to the Federal Deposit Insurance Act and administered by the FDIC.

(a) Would the FDIC really need authority to override Federal law?

(b) Would it be feasible to narrow the authority to override State law?

A.9. The practical effect of the overrides referred to in the question is that the FSLIC has been able to assist the acquisition of failed or failing thrifts (a) by any kind of company and (b) without limitation as to the location of the company. The FDIC has had much narrower emergency authority to allow interstate acquisitions of failed or failing banks in certain circumstances but we have not had authority to allow for acquisition by companies other than those allowed under the Bank Holding Company Act.

In its study, Mandate for Change, the FDIC discussed why it believes that with appropriate firewalls it would be proper public policy to allow for the ownership of financial institutions by a company engaged in any kind of business--in other words, why restrictions like those in the Bank Holding Company Act and the Glass-Steagall Act should be removed. The savings and loan industry is in substantial need of new capital. Significant amounts have come from non-traditional sources that have been allowed to acquire distressed associations. It is important that the insurer have continuing access to these capital sources. The proposed legislation would also make it clear that the FDIC could look to bank holding companies as a potential acquirer of distressed thrifts, thus further expanding the potential sources of new capital.

The restraints of state law are primarily geographic in terms of branching and/or interstate activity. The ability to override these restrictions has significantly increased the options available for handling failed and failing cases.

Since any limits on competitive bidding are likely to increase the cost to the FDIC of resolving problem situations, we hope that the Congress will give us the maximum flexibility to sell distressed thrifts, and banks too for that matter, to the broadest range of types of acquirers and without regard to geographic location restrictions.

We note that the proposal provides for a check on the FDIC's use of the authority by requiring Federal Reserve concurrence in any override of the Federal Reserve or Bank Holding Company Acts and FHLBS concurrence in any override involving a failing thrift. States would be consulted on any override of State law. We hope that any concerns over the amount of outside capital or the terms of previous acquisitions will not prejudice a conclusion that the insurer should have the broadest power to negotiate sound transactions.

Q.10. Please describe the capital standards currently applicable to nonmember insured banks. What level of capital is required? What qualifies as capital?

A.10. The FDIC's capital standards include a leverage ratio and a new risk-based ratio. We emphasize that both tests are minimums and most banks are expected to operate above the floor based on their own risk profile and the several kinds of risk which are not quantified into the formulas.

The leverage standard divides capital into primary and secondary components. For leverage purposes, total capital (primary plus secondary) must equal 6 percent of total assets and primary capital must equal at least 5 1/2 percent of total assets. Primary capital includes common equity capital, perpetual preferred stock, minority interests in consolidated subsidiaries, the allowance for loan and lease losses, and limited amounts of mandatory convertible debt, less all intangibles other than mortgage servicing rights. Secondary capital includes subordinated debt and limited-life preferred stock.

The risk-based framework will require banks to meet a minimum ratio of qualifying capital to risk-weighted assets of 7 1/4 percent by year-end 1990 and 8 percent by year-end 1992. For risk-based capital purposes, qualifying total capital consists of core (tier 1) capital and supplementary (tier 2) capital. At least one-half of the bank's total capital requirement should consist of tier 1 capital and tier 2 capital cannot exceed 100 percent of tier 1 capital. Core capital includes common equity capital, noncummulative perpetual preferred stock, and minority interests in consolidated subsidiaries, less all intangible assets other than mortgage servicing rights. Supplementary or tier 2 capital includes the allowance for loan and lease losses, cumulative preferred stock, mandatory convertible debt, limited-life preferred stock, and term subordinated debt.

Once the new risk-based capital framework is fully implemented, the FDIC believes there will remain a need to maintain a leverage constraint at some level that is consistent with the current 6 percent capital to total asset requirement. The FDIC, in conjunction with the FRB and OCC, will consider whether the primary and secondary capital definitions used in the leverage ratio should be replaced with the core and supplementary capital definitions used in the risk-based framework. Assuming that such a revision to the leverage definitions are made, it is possible that the 5 1/2 percent primary capital requirement could be replaced with a lower core capital requirement since the core capital definition is much more restrictive than the primary capital definition by not including cumulative preferred stock, mandatory convertible debt or the allowance for loan and lease losses.

Q.11. Will the current capital standards continue to apply once the new risk-based capital standards take effect? If so, do you anticipate making any modifications in the current standards?

A.11. See answer to question 10 above.

Q.12. Concern has been expressed (a) that stronger capital standards could cause many marginally healthy thrift institutions to fail, and (b) that these additional failures would increase the cost of dealing with FSLIC's problems. What is your response?

A.12. Although the ultimate judgment on what constitutes adequate bank or thrift capital (from the insurer's perspective) is difficult to quantify, we can learn from recent events. The thrift industry crisis has shown what can occur when deposit insurers are unable to close insolvent institutions. The resulting problem has been demonstrated by the willingness of some insolvent thrift owners and managers to engage in fraud and risky activities. The result of this lack of regulatory and market discipline has been a growing liability for the FSLIC. Thus, while some marginally solvent thrifts will fail to ever reach the proposed capital standards, this should be seen as the preventive measure it is intended to be. By increasing the capital buffer between depository institutions and their insurers, one can increase market discipline and lower long-run failure resolution costs. This is not to say that all marginally solvent thrifts will eventually become insolvent. The insurer should be allowed and be willing to make discretionary use of capital forbearance in cases where a real chance for recovery exists. The President's reform plan does not call for the immediate closing of thrifts failing to meet the stronger capital standards, but rather calls for restriction of asset growth of undercapitalized thrifts. The regulators can be expected to place appropriate operating controls on any thrift that does not meet the capital standard but failure is by no means automatic.

Our analysis of thrift industry capitalization indicates that many solvent and profitable thrifts are likely to be unable to meet the proposed capital standards by mid-year 1991. Preliminary estimates based on year-end 1988 data indicated that 928 GAAP-solvent, profitable thrifts with combined assets of $583.6 billion have less than 6 percent total capital. The combined total capital shortfall for these 928 thrifts is estimated at $10.3 billion. However, the capital target appears to be achievable for many of these thrifts over a phase-in period somewhat longer than two years. The actual amount of time needed to meet the capital standards is highly dependent upon future thrift profitability.

Q.13. Concern has been expressed that if a thrift institution were unable to meet applicable capital standards by June 1, 1991, the Administration's proposal would require that the institution be sold or liquidated.

(a) Is that true?

(b) What consequences would a solvent institution face if it were unable to meet applicable capital standards?

(c) Was there any interagency agreement on this point during the discussions in which the Administration's proposal was developed?

A.13. (a) The legislation states that the Chairman of the Federal Home Loan Bank System "prohibit the asset growth of any savings association . . . not in compliance with capital standards . . ." Such language would not require a thrift to be sold or liquidated, but would halt growth, presumably until such time as the capital standards were met.

(b) If no time limit is placed on reaching proper capital standards, it is possible a thrift could simply continue to operate without growing. This option would not be desirable for either the thrift or the system over the long run. It is important that capital standards be reached for all thrifts. Lack of sufficient capital would tend to stifle a thrift's ability to compete in the marketplace and, might induce excessive risk taking by management.

Hopefully, the capital requirements would result in thrifts raising capital to meet the guidelines and thus regain growth status. This would require finding outside sources of capital, directing more earnings toward capital formation and away from the payment of dividends or other uses or seeking merger opportunities with better capitalized institutions. In other words, a solvent institution which has inadequate capital can expect special, close supervision and regulatory operating restraints designed to prod corrections. This might include cease-and-desist action and in extreme cases termination of insurance proceedings might be considered.

(c) Other than the agreement on growth restrictions, we are not aware of any other interagency agreements regarding the treatment of undercapitalized thrifts. We believe that the assumption was that they would be treated in the same way that banks are treated in the same circumstance.

Q.14. Section 208 of the Administration's proposal contains references not only to the Bank Insurance Fund and the Savings Association Insurance Fund but to "the Deposit Insurance Fund as a whole." Could insurance premiums for one fund be increased because of problems confronting the other fund?

A.14. No. The funds are to be kept separate and are not to be commingled. Premiums for each fund are to be set independently, without regard to the level or condition of the other fund. It is not intended that a deficiency in, or projected losses to, one fund could result in an increase in premiums for the other fund. The language referring to "the Deposit Insurance Fund as a whole" has been eliminated.

Q.15. You have been quoted as supporting the continued use of tax benefits as incentives for the acquisition of insolvent thrift institutions.

(a) Is that because you believe that tax benefits lower the cost to the Government as a whole of dealing with such institutions?

(b) If so, what supporting evidence can you provide? If not, is it because you fear that the proposed financing package will prove inadequate?

A.15. (a) and (b) We do not believe the tax benefits would lower the cost to the government as a whole, although they do lower the cost to the insurance funds. We presently also have no reason to fear the proposed financing package will prove inadequate. We believe, however, that the tax provisions are important primarily because they provide certainty and clarity as to the tax treatment of failing and failed bank and thrift assistance transactions. By clarifying the tax treatment of the transactions, the government is spared the "whipsaw" effect which we believe occurred prior to enactment of the provisions. This effect can occur when acquirers of failed or failing institutions factor a large tax cost into their bids because they claim the tax treatment of FDIC assistance is uncertain. They then, however, take aggressive positions on their tax returns asserting that FDIC assistance was non-taxable. This results in the worst possible revenue impact to the government.

We do not object to the provisions expiring as scheduled. However, we believe it is very important to maintain those provisions that make clear that FDIC assistance to "fill the hole" between the value of the liabilities assumed and the assets acquired is tax-free to the acquiring institution.

Q.16. Under the Administration's proposal, the FDIC's Board of Directors would be expanded from three members to five, and the Comptroller of the Currency and the Chairman of the Federal Home Loan Bank System would be members _ex officio_. On February 12, 1989, the _New York Times_ reported that the Federal Reserve Board had sought to have its Vice Chairman included on the FDIC board, but that its request has been rejected.

(a) Did the Federal Reserve Board seek representation on the FDIC board?

(b) In the discussions during which the Administration's proposal was developed, did you express any opinion on whether the Federal Reserve should have such representation. If so, what views did you express?

A.16. (a) During discussions concerning the makeup of the FDIC Board several people were considered as possible additions and that might have included a member from the Federal Reserve Board. The General Counsel of the FRB specifically sought representation on our Board.

(b) We expressed a strong opposition to FRB representation on the FDIC Board and the FDIC objected to the Board composition contained in the Senate Banking Committee Print. We believe it is inappropriate and unwise to include on the FDIC Board three primary federal regulators of the financial institutions industry and only two independent public members. That results in an FDIC Board the majority whose paramount interests are other than those of the insurance agency.

Our experience has been that the federal regulators who are charterers bring the views and biases of their own agencies to the FDIC Board -- which views sometimes are at cross purposes with the primary mission of the FDIC, i.e., protection of the fund. The FRB is equivalent to a charterer since it has its own special interest in FRB member banks and bank holding companies. Furthermore, the FRB has other responsibilities, like international finance and monetary policy, that may conflict with the interests of the insurer.

The best interest of the insurer is to have independent public members be in the majority -- as has been true during the entire history of the FDIC -- rather than having the insurer captive to the charterers.

Q.17. We have heard that some states have done a poor job of preventing unscrupulous or otherwise unqualified persons from obtaining control of federally insured banks and thrift institutions -- and then engaging in fraud or other insider abuse that has been costly for the deposit insurance funds.

(a) What is your response?

(b) Do you believe that the federal change-in-control statutes need to be strengthened?

A.17. There exists among the states a wide range of legal restraints aimed at preventing unscrupulous or otherwise unqualified persons from obtaining control of a bank or thrift chartered by the states. A few states have enacted change-in-control laws similar to the federal statute, but most states rely on the federal statute to keep undesirable people out of ownership positions in financial institutions. Obviously, those state statutes requiring a review of personal qualifications prior to permitting a change in control transaction to proceed provide a double check on the federal regulator.

Nevertheless, we believe the federal change-in-control statute to be adequate to protect the deposit insurer, provided the regulator performs a thorough background investigation of the proposed acquirers. The Change in Bank Control Act was strengthened in 1986 when Congress directed regulators to require public notice of a person's intent to acquire a financial institution and required the regulator to conduct an independent investigation into the financial background of the proposed acquirers. These changes increased the Act's deterrent value and strengthened the regulator's ability to disapprove a Notice of Acquisition of Control. To encourage uniformity among the agencies, interagency guidelines for conducting background checks were adopted on January 22, 1988.

The strengthened civil penalty provisions contained in the proposal should help to compensate the insurance funds for any losses resulting from an illegal takeover of an insured institution and further deter individuals from filing false information to influence the regulator to act favorably on a Notice. (See Q.18 for comments on maximum level of penalties.)

We are particularly supportive of the provision in S. 413 eliminating the de novo judicial review of the validity and appropriateness of any final order imposing a penalty where such penalty has not been paid and has been referred to the Attorney General for recovery in District Court. The legislative proposal provides for direct appeal to the U.S. Court of Appeals under the standards of the Administrative Procedures Act as currently applied to review of other financial institution enforcement proceedings.

The filing of false information to influence the FDIC to act favorably on a change in control notice has been successfully prosecuted under 18 U.S.C. 1007. However, there are no provisions to strengthen criminal prosecution of individuals who willfully ignore the filing requirements of the CBCA. Failure to file a notice when required by the CBCA, escapes the purview of section 1007 and must be addressed under another statute, usually 18 U.S.C. 371, conspiracy to defraud the U.S. To correct this situation, we suggest that 18 U.S.C. 1007 be expanded to include the failure to supply information at the time required by law or regulation for the purpose of influencing the action of the FDIC, OCC, FHLBS, or FRS.

Q.18. The enforcement provisions of the Administration's proposal have been criticized as "overkill" and "unnecessary." What is your response? Why are those provisions justified?

A.18. Many of the provisions of the Administration's proposal have previously been considered and approved by both the Senate and House Banking Committees. These amendments were prepared through a joint effort of the financial regulatory agencies. They represent a coordinated effort to solve many enforcement problems that had become apparent through agency interpretation of existing statutory law and through judicial interpretation of law and regulations. We believe these provisions are very important in our efforts to effectively carry out our enforcement duties.

The primary difference between the Administration's proposal and that of the joint regulatory agencies is the large increase in penalties, particularly civil money penalties, in the Administration's plan. We support increases as recommended by the Administration but believe the amounts could be adjusted without unduly jeopardizing our supervisory ability.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
L. WILLIAM SEIDMAN

Q.1. We have heard a great deal of testimony about the abuses of direct real estate investment authority by state-chartered thrifts in places like California and Texas. But state-chartered banks also have direct investment authority in certain states. My question is this: all other federal regulators prohibit or sharply curtail the direct real estate investments of depository institutions. The Comptroller prohibits it for national banks; the Fed prohibits it for state member banks and bank holding companies; the Bank Board now puts severe limits on such investments; and credit unions cannot engage in such activities. Why is the FDIC the only federal regulator that has no federal regulations governing direct real estate investments by depository institutions?

A.1. To the best of our knowledge, the Federal Reserve does not have any existing rule or regulation which explicitly prohibits state member banks from investing in real estate where such activity is authorized by state law. It is our understanding, however, that the Fed effectively has been prohibiting real estate investment activity in state chartered member institutions on a case-by-case basis through the application process. In addition, they have proposed a regulation which would permit a nominal amount of passive real estate investment activity to be conducted in a subsidiary of a bank holding company. National banks currently are not permitted to engage in real estate investment activity under the National Banking Act but, as is discussed later, the equation for what is a real estate investment versus what is a real estate loan can be adjusted to meet an institution's objectives.

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The FDIC elected to withhold adopting any formal regulations governing bank involvement in real estate investment only after an extensive study of the subject. In 1984, the FDIC initiated a rulemaking procedure which would have prohibited real estate investment with certain exceptions. Subsequently, the proposal was revised and issued for comment again in 1985, a public hearing was held and a joint or parallel regulation was extensively discussed with the Federal Reserve and the Comptroller of the Currency.

In 1987, the FDIC Board withdrew its proposal, noting that existing studies needed to be updated, current events in the marketplace needed to be analyzed, and recent instances of safety and soundness problems needed to be studied. Preliminary indications were that there was no system wide problem posed to insured state nonmember banks as a result of state granted real estate investment powers that could not be handled on a case-by-case basis through the examination and supervisory process.

In dropping its proposal, however, the FDIC Board stressed that its action was not prompted by a decision to discontinue efforts toward establishing guidelines for the safe and sound conduct of real estate investment activities by insured banks and their subsidiaries and affiliates. Rather, it was their intent that staff actively continue to study bank involvement in these activities and continue to address any safety and soundness problems on a case-by-case basis.

Informal surveys of this matter over the past year have reported only a small number of state nonmember banks engaging in real estate investment activities in those states that allow it. The principal reason seems to be that current accounting rules provide a great degree of latitude for reporting transactions as loans versus investments. Our experience indicates that a bank is more likely to structure a transaction as a loan with an "equity kicker" than as a real estate investment.

A number of steps are being taken to address the real estate investment area. The FFIEC has amended its definition of real estate investment for bank reporting purposes and has expanded the data collected in this area. The FDIC staff is studying proposals to exclude an institution's investment in a real estate investment subsidiary from bank regulatory capital, to require a prior notice of intent to engage in a nontraditional banking activity or to acquire or establish a nonbanking subsidiary, and to address conflicts of interest that arise when a bank and/or its subsidiary is an equity participant in real estate investment in which a bank insider is involved. We are not ready to make recommendations on any of these ideas at this time.

From an overall supervisory standpoint, we continue to emphasize the need for corporate separateness of subsidiaries, adequate capitalization at all levels of an organization and aggressive supervision, particularly when insider and insider-related transactions are present.

One of the strengths of our dual banking system is the innovation that can occur at the state level in developing new banking products and services. Generally, we prefer to let the states establish their own banking statutes and would intercede only when there is a clear risk to the insurance fund that cannot adequately be addressed on a case-by-case basis through the examination and supervisory process.

In all, the FDIC intends to continue to closely monitor the real estate investment area and to implement changes in its regulatory and supervisory areas as it deems necessary and appropriate.

Q.2. I am concerned about the zeal to put thrifts under bank accounting practices, with no deviations. I am not saying that thrifts should get off more leniently. I am only saying that certain characteristics of thrifts require regulations that are tailored to what thrifts do -- at least the traditional ones -- which is make mortgage loans. The Bank Board recently proposed a tough risk-based capital standard that takes into account interest-rate risks -- which the banks' regulation does not do. Interest-rate risk is a particular problem in the thrift industry, as you know. Will the new plan ignore this and other similar innovations? I have heard talk about imposing the more restrictive of the two sets of rules in any situation, but that may be too severe. What is your view?

A.2. Under the FDIC's existing capital regulation, insured banks supervised by the FDIC are required to meet at least certain minimum levels. In addition, banks are also expected to meet any additional capital requirements established by their primary state regulator that exceed our minimum. Although interest rate risk is not explicitly factored into our capital ratio formula, other risks such as interest rate exposure are considered in determining how much over the minimum a given institution should have.

Thus, financial institutions under the FDIC's supervision very well may be required to maintain capital over and above the regulatory minimum if such institutions are exposed to significant levels of interest rate risk. The FDIC, OCC and FRB, in conjunction with banking regulators from other industrialized countries, are also continuing their efforts to devise a systematic approach for explicitly factoring interest rate risk into the new risk-based capital requirements. The formula proposed by the FHLBB is being given attention by us. In the interim, interest rate risk continues to be evaluated on a specific case basis and, where appropriate, supervisory action will be taken against institutions deemed to be engaging in unsafe and unsound practices with regard to their asset/liability management policies and interest rate sensitivity positions.

Q.3. Chairman Riegle and I led a fight during the CEBA legislation to exempt the bank and thrift regulators from Gramm-Rudman and OMB apportionment. We won, but OMB fought us every step of the way. In the Administration plan, will any of the regulators become subject once again to either Gramm-Rudman or apportionment? I am very concerned that Bank Board and Comptroller regulators will be subject to federal pay and staffing restrictions, while the other bank regulators will not be restricted. How does the Administration plan address this issue?

A.3. It is our understanding that the proposed legislation does not change the present status of any of the existing federal financial regulatory agencies under either the Gramm-Rudman or the Anti-Deficiency Acts. However, the newly created Resolution Trust Corporation and Resolution Funding Corporation would be subjected to the Anti-Deficiency Act, but would be exempted from Gramm-Rudman under section 717 of the bill. The other funds and funding entities covered by the proposed legislation could, however, be indirectly impacted by the Gramm-Rudman and the Anti-Deficiency Acts to the extent appropriated funds are made available to such entities by the Secretary of the Treasury pursuant to various provisions of the proposed legislation.

We are concerned, however, that the reporting requirement of Section 217 of the bill, insofar as FDIC is required to report to OMB, could lead to future problems with respect to our independence. We have provided the Committee legislative language requiring us to report to the Treasury Department, but retaining our independence from OMB.

Also, section 1103 of the bill would authorize the Comptroller of the Currency to fix employee compensation in general comparability with the other federal financial regulatory agencies, without regard to any other law. Similar authority is granted the Resolution Trust Company under section 501 and to the Federal Home Loan Bank System under section 702(e).

Q.4. The Administration proposal gives the FDIC the authority to establish an "entrance fee" to FSLIC-insured institutions that want to move to the FDIC after the moratorium comes off in five years. This entrance fee is to "prevent dilution" of the appropriate reserve-to-deposit ratio. Does this mean that the fee charged will be keyed to the target rate of 1.25 percent of deposits? Or will the newcomer only be charged whatever the actual FDIC reserve-to-deposit ratio is at the time that it acquires FDIC insurance?

A.4. The Administration's proposal would give the FDIC authority to levy an "entrance fee" on FSLIC-insured institutions seeking FDIC deposit insurance when the moratorium is lifted. This fee would prevent dilution of the reserve-to-deposit ratio. Newly FDIC-insured institutions should be charged an amount necessary to maintain the reserve-to-deposit ratio in effect at the time the insurance is obtained. Suppose the actual ratio was 1.0 percent when the institutions applied for FDIC insurance. Because premium levels would rise gradually until the target ratio is reached, all FDIC-insured institutions, including any new entrants, would be required to pay higher premiums to raise the deposit insurance fund to 1.25 percent of insured deposits.

If new entrants paid an amount equal to 1.25 percent upon entry to the fund when the actual ratio was less than that, through the higher assessments on all FDIC-insured institutions, new entrants would be paying to not only bring themselves up to the appropriate ratio, but for others as well. Similarly, if the actual ratio were above 1.25 percent, new entrants should pay the higher rate since their future assessments will be lower as adjustments are made to lower the fund to deposit ratio to 1.25 percent.

Q.5. Many have criticized certain accounting practices of thrifts, especially the practice of lending the full amount of principal, several years of interest, and certain loan fees in connection with real estate development deals. That permits a developer to use borrowed money to pay interest and loan fees before any revenue is generated by a development project. It also permits the S&L to book the return of the money just lent as "profit" that it can use to pay massive dividends to insiders. I have several questions: First, isn't it true that bank real estate loans are accounted for the same way? Second, should Congress put a stop to the practice for both thrifts and banks? Finally, should borrowers be required to guarantee repayment personally in addition to using the real estate collateral? Wouldn't that help curb speculative ventures while at the same time giving the institution and the insurance fund a better chance of recovery in the event of losses?

A.5. Questions regarding the appropriate accounting treatment for real estate development loans is an area that has been subjected to a good deal of attention in recent years. This interest is partially due to the perception that savings and loan associations, as well as some banks, may have artificially accelerated loan income as a means of paying hefty dividends to owners and large bonuses or management fees to insiders.

In view of this potential for abusive accounting practices, several initiatives were undertaken by the accounting profession. For example, the

Financial Accounting Standards Board, in 1986, issued Statement of Financial Accounting Standards No. 91 (FASB 91). This accounting principle provides that lenders, including banks and savings and loan associations, cannot recognize mortgage points and other nonrefundable loan fees immediately as income, but rather must defer the fees and recognize these amounts over the life of the loans as an adjustment in yield. In addition, in 1986, the accounting standards executive committee of the AICPA issued a Notice to Practitioners on the accounting for acquisition, development, and construction (ADC) loans. This Notice, which superseded two earlier Notices issued in 1983 and 1984, effectively requires certain ADC arrangements to be accounted for as joint ventures or direct investments in real estate rather than as loans. For arrangements accounted for as joint ventures or real estate investments, the recognition of income is much slower than if the ADC arrangement were accounted for as a loan. For ADC arrangements that are accounted for as loans, safety and soundness concerns should be addressed promptly by the regulators if an institution has significant concentrations of credit in the form of development loans that are 100 percent or more financed by the lender without recourse to any substantive assets of the developer other than the real estate project being financed.

The question points to a potentially very serious credit problem in insured institutions and one to which we believe our examiners are attuned. The FDIC does not believe legislation is necessary to establish accounting standards for real estate development loans. As to requiring individual developers to personally guarantee real estate development loans we suggest that a problem does exist and debate on how to deal with the matter is needed. Without further study, however, we would not recommend legislation at this time. In the meantime, prudent lending limits and aggressive supervision by all regulators should be used to minimize the potential for unsafe and unsound banking practices.

Prudent practices, which we seek to enforce, would require that the developer had a proper equity investment in a project, that feasibility studies are rigorous and clearly indicate probability of repayment even if interest advances are included in the loan, and that personal guarantees or personal liability or extra collateral are obtained in appropriate circumstances.

Q.6. Many have spoken frequently of the "moral hazard" that occurs when a federally-insured depository institution's capital has been substantially depleted. The managers of such an institution have an incentive to make risky investments because they no longer have a substantial amount of capital that they would lose if the investments went sour. Isn't the same "moral hazard" present when an institution's market value capital drops substantially, even if its GAAP capital does not? If so, should Congress require depository institutions to begin some form of market value reporting?

A.6. The "moral hazard" as it relates to management in banks with insufficient capital levels can exist whenever a bank's GAAP capital or market value capital drops to a nominal or negative amount. In view of this, the FDIC's capital regulation provides that whenever a bank's capital level falls below 3 percent of assets, the bank is deemed to be operating in an unsafe and unsound condition and therefore potentially subject to termination of insurance proceedings under section 8(a) of the FDI Act.

This calculation of capital is generally based on GAAP capital, even though the market value of a bank's capital may be lower. Although the FDIC is not willing at this time to support a complete "mark-to-market" concept for all of a bank's assets for accounting and bank solvency purposes, the FDIC attempts to ensure that losses on loans are promptly written down and that securities not intended to be held to maturity are marked-to-market. Thus, a semblance of market value accounting already applies to two of a bank's largest categories -- loans and securities.

However, a complete market value approach for all of a bank's assets, particularly loans for other than residential real estate purposes, would be difficult for many banks to implement with any reasonable degree of precision in view of the lack of common underwriting standards and the absence of independent investment ratings or other outside objective criteria for evaluating the fair value of many of these loans. From a practical viewpoint, many loans are not liquid assets, nor are they actively traded in any secondary markets. In view of this, many financial analysts actually prefer using historical costs as a starting point when tracking a bank's actual and projected net income streams and balance sheet positions. They make their own rough adjustments for any significant book value versus market value differences, rather than using financial statements that have already been adjusted for fair value estimates. From a supervisory viewpoint, any major difference between GAAP capital and market value capital generally is due either to significant credit quality problems or excessive levels of interest rate risk, both of which can be adequately addressed through aggressive supervisory action by banking regulators.

We do not believe Congress should require market value accounting for the simple reason that no readily available accepted method of doing so presently exists. The accounting industry continues its study of methodology and institutions may begin to show at least some market value information in the notes to their financial statements. FDIC applauds and urges continued work in devising a generally accepted market value reporting system that would apply fairly and equally to all financial institutions.

Q.7. Under the Administration legislative proposal, what exactly is the capital standard that thrifts must satisfy by the 1991 deadline? Is it a flat 6 percent of assets? Is it the risk-adjusted ratio of 7.25 percent, which later goes up to 8 percent? Is it the higher of these two standards? There is significant confusion about this important question that needs to be cleared up.

A.7. Under section 314 of S.413, the Administration's legislative proposal, savings and loan associations would be subject to uniform capital standards established by regulations promulgated by the Chairman of the Federal Home Loan Bank System. The capital standards could be no less stringent or materially lower than the capital standards established for national banks by the Office of the Comptroller of The Currency except that any goodwill existing on the date of enactment of the proposal could be amortized as determined by the Chairman with the concurrence of the Secretary of the Treasury. Moreover, except for an investment in or loan to a subsidiary engaged solely in mortgage banking, any investment in or loan to any other subsidiary engaged in activities not permissible for a national bank must be deducted from capital.

In essence, the Administration's proposal keys the capital standards for savings associations to those that may exist from time to time for national banks with some special exceptions and a measure of discretion vested in the Chairman of the Federal Home Loan Bank System to vary the standards to some extent from those that may be applicable to national banks. At the moment, the Comptroller of the Currency has established for national banks capital standards calling for the maintenance of leverage ratios of 5.5 percent primary and 6 percent total capital to total assets and risk-based capital ratios of 7.25 percent by year-end 1990 and 8 percent by year-end 1992 on risk-adjusted assets. The actual standard that savings and loans will therefore have to achieve will depend on the requirements that apply at any given time to national banks and the formulas and benchmarks to be set by the FHLBS in regulations.

Q.8. With respect to your views on the need to separate the regulator from the insurer, I note that with respect to state nonmember banks, the FDIC plays both roles. While these institutions are chartered by the states, the FDIC is the primary federal regulator, setting capital and other prudential standards. According to your testimony, there should be an internal conflict between the FDIC's role as regulator in trying to promote new powers and products and its role as insurer. Is there any evidence that such a conflict exists? Is the FDIC's regulatory role with respect to these institutions in any way less stringent than the regulatory role imposed by the OCC or the Federal Reserve Board? If not, does this indicate that the existing FDIC model as both regulator and insurer over state nonmember banks is acceptable regulatory structure?

A.8. While the FDIC is the federal regulator of state nonmember banks, it is not the primary one. The state chartering authority is. The FDIC advocates the separation of the charterer from the insurer, not regulation from insurance. In fact, we believe the insurer must have some regulatory authority over all insured entities. Conflicts of interest are a concern in cases where the deposit insurer may be controlled by the chartering authority (which is considered to be the primary regulator). The insurer and the charterer respond to different incentives, particularly in deciding when a failed institution is to be closed. The insurer usually will prefer quick action, in order to protect the insurance fund, since the costs of any delay are borne by that fund. The charterer, on the other hand, may have practical reasons for delaying a closing. These may include concerns about the impact on the local economy (and a desire to diminish the impact by waiting for a more opportune moment), political considerations, or various motives for avoiding unnecessary revocations of charters granted under its authority (charterers tend to promote their particular segment of the industry).

Separation of the charterer and insurer provides for balance in weighing these competing considerations. To place the insurer under the control of the chartering authority is to bias decisions toward promotion of the franchise over potential cost to the insurance fund.

The FDIC's "promotion" of new powers is a direct result of its concern for bank safety and soundness in its role as insurer. Support for new powers housed in separately capitalized subsidiaries or opposition to exercise certain powers directly within a bank follows from an understanding of levels of risk, portfolio diversification, economies of scale, and the contributions these can make toward a profitable, safer, more stable banking system. There is no conflict of interest apparent in this example, nor do we see a comparable potential for conflicts of the type inherent when the charterer and insurer are related.

Q.9. Prior to 1950, the FDIC had no authority to examine national banks or state member banks without the consent of the Comptroller of the Currency of the Federal Reserve Board. In that year, Congress authorized the FDIC to conduct "special examinations" of these institutions, if approved by the FDIC board. The legislative history of this amendment includes a letter from Maple Harl, then Chairman of the FDIC, in which he states that the FDIC will only use this authority for problem institutions which the FDIC determines may lead to a loss to the Corporation.

Are you satisfied with the FDIC's present authority to conduct special examinations of national banks and state member banks? Do you interpret the Administration's proposal as affecting your authority to conduct such examinations?

A.9. The Administration's proposal would not affect our existing authority to conduct special examinations of national and state member banks. We would prefer, however, a clearer statement of that authority that does not suggest the need for a case-by-case determination by our board of directors as to when to conduct such an examination. In our view, FDIC should be the sole judge, based on all information currently in its possession, when such examinations are necessary in order to determine the nature and extent of insurance risk. Moreover, we believe that such decisions can be made routinely by appropriate FDIC supervisory officials under general guidelines without special action by the FDIC Board of Directors.

The statement made by former Chairman Maple Harl is in our view, too narrow, overly constraining and in some sense, places the cart before the horse. The purpose of any such examination is to determine the condition of a national or state member bank, that is, whether it is in fact a problem bank and if so, what are the nature and extent of its problems. If we were confident of these elements at all times, there would never be a need to conduct a special examination. In sum, we would prefer a clear, unqualified statement that the FDIC may examine any national or state member bank whenever necessary for insurance purposes.

Q.10. The Administration's plan calls for case resolution of $10 billion in the remainder of FY 1989, $25 billion in FY 1990, and $17 billion in FY 1991. Half of these case resolutions are projected to be liquidations. Is this enough of an up-front infusion of money to resolve the insolvencies you already know about? The proposed sums are obviously already large, but could the insurer profitably spend even larger sums in the first year or so to get this problem behind us? I realize that assisted mergers take time to put together and drain human resources; there obviously is a cap on the number of these that can be done in any one fiscal year. But it seems to me that liquidations or depositor payouts could be done much more quickly once you have identified the institutions that require this treatment. Isn't it just a matter of writing checks to depositors or transferring deposits to nearby institutions, which can be done relatively quickly? Furthermore, I would think that given the lack of cash available over the last several years, FSLIC must have focused its attention on the institutions that were capable of assisted mergers, which require less cash, while the proportion of liquidation candidates left in the unresolved case pool presumably went up. In short, if liquidations are cash intensive, if there are a large number of liquidation candidates already identified, and if liquidations are relatively quicker to accomplish in terms of the up-front cash payout; does the Administration's plan include adequate up-front cash in the first three years?

A.10. Paying-off insured depositors and retaining assets for liquidation is a very cash-intensive method of handling insolvent institutions. For this reason, the FSLIC generally has refrained from this method, concentrating its limited resources on completing assisted mergers of failing thrifts. Once the resources become available, however, many of the insolvent institutions will need to be liquidated, though the possibility of selling some of these S&Ls still remains. We believe that the RTC should strive to sell failed-thrift assets at fair market values as quickly as possible to replenish the resources of the fund. In addition, the use of insured-deposit transfers and total-asset or small-loan purchase-and-assumption transactions can reduce the outlays required to complete cost-effective deals. While it is difficult to accurately estimate the total cost of resolving the S&L problem, the figures presented in the Administration's proposal seem reasonable.

Q.11. Under the Administration's proposal, savings associations must use bank accounting standards by 1994. Before that date, to what extent will they be able to use regulatory accounting standards? For example, will they be able to continue to defer loan losses during this period? If so, will savings associations really be meeting bank capital requirements prior to the change to bank accounting standards?

A.11. Bank capital standards generally require the deduction of intangibles such as goodwill when calculating the amount of a bank's regulatory capital. In addition, with the exception of limited amounts of loan losses that qualifying agricultural banks are allowed to amortize over a period not to exceed seven years, banks are not allowed to defer loan losses for regulatory capital purposes. Thus, if the bank capital and accounting standards were applied to savings and loan associations exactly as they are applied to banks, the deferred loan losses presently reflected by S&Ls could no longer be recognized as balance sheet assets or as part of regulatory capital. In addition, although goodwill may be reflected as a balance sheet asset for bank accounting purposes, provided it is amortized over a period not to exceed 15 years, goodwill and other intangibles (except for mortgage servicing rights) are deducted when calculating regulatory capital. If S&L's are to truly meet the bank's capital standards by June 1991, as proposed under the Administration's proposal, the deduction for regulatory capital purposes of an S&L's deferred loan losses and goodwill accounts would be necessary. However, the proposal specifically allows a phase-out of goodwill for savings and loans. In sum, the answer to the question depends on the capital regulations that the FHLBS must adopt. If the rules are to be "no less stringent than the capital standards applicable to national banks", the regulations will have to address the question of definitions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PRESSLER FROM L. WILLIAM SEIDMAN

Q. 1. Chairman Seidman, you of course know that the Administration's legislative proposal for the S&L industry requires credit unions to expense the one percent of deposits they maintain at the National Credit Union Share Insurance Fund over an 8-year transition period at the end of which it would commence collecting a 1/12 of one percent premium from them. In 1985, credit unions recapitalized the Fund by depositing the equivalent of twelve annual insurance premiums in advance. I understand the Fund's equity-to-insured share ratio is 1.26 percent of insured savings. This compares to the current FDIC ratio of .83 percent. I also understand over the last five years the Fund's average insurance loss per $1000 of insured shares has been $.34. During the same time FDIC's average loss per $1000 has been $1.29, while the FSLIC's losses have exceeded $7.00 per $1000.

In view of these facts, will you please explain the Administration's rationale in proposing that credit unions expense their deposits for eight years and then commence paying premiums of 1/12 of one percent?

A.1. The relatively strong financial position of the National Credit Union Share Insurance Fund (NCUSIF) today does not reflect that the same capital is found as credit union capital as well. Futher, the recapitalization of the NCUSIF in 1985 is a sufficient reminder that despite the strong position of the fund today, larger losses are possible at some future date. As recently as 1980, the FSLIC reserve-to-insured deposits ratio was 1.28, compared to the year-end 1987 ratio of negative (1.47). The FDIC has also seen a decline in its reserve-to-insured deposit ratio from 1.16 in 1980 to 0.83 in 1988. In general, reserve-to-insured deposits ratios should not be used as the sole indicator of insurance fund adequacy, since the ratio will rise or fall after failures have occurred. The adequacy of an insurance fund depends not only upon reserve levels but the present and future health of the insured institutions.

The President's reform plan recognizes that credit unions are not immune to financial distress and attempts to avoid one flaw in the present funding of the NCUSIF. Under the present system both the credit unions and the NCUSIF have a claim to the contributions. Should the NCUSIF need to draw upon those funds, credit unions' assets and capital will decline on a dollar for dollar basis. Therefore, the existing funding scheme can create a domino effect, with credit union insolvencies resulting in reductions in capital for remaining credit unions. The Presidents' reform plan calls for an amortization of the NCUSIF refunding contributions by credit unions over an eight year period. The plan recognizes that the contributions should be assets solely of the NCUSIF and that these funds may be needed in the future. The eight year amortization period allows for a more gradual reduction in that component of credit unions' assets and capital than might occur otherwise.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE
FROM M. DANNY WALL

(SENATOR RIEGLE)

Question 1

Under the Administration's proposal, the FDIC would have certain authority to prohibit or restrict the exercise of state-authorized powers by federally insured thrift institutions. Would that authority really be any broader than the authority currently possessed by FSLIC? If so, in what ways?

Answer

Neither the Federal Home Loan Bank Board or the Federal Savings and Loan Insurance Corporation currently has clearly expressed statutory authority to prohibit state-chartered institutions from engaging either directly or indirectly in an activity not permitted for a federal association under the Home Owners' Loan Act.

The United States Court of Appeals for the District of Columbia Circuit just this past year recognized the authority of the FSLIC to regulate the activities of state-chartered institutions for the purpose of protecting the integrity of the FSLIC Fund. In affirming the FSLIC regulations limiting direct investment by FSLIC-insured institutions, the court in *Lincoln Savings and Loan Association* v. *Federal Home Loan Bank Board*, 856 Fed. 1558 (D.C. Cir. 1988) stated:

> The ability of the FSLIC to provide that protection depends in substantial part on the integrity of the fund created under the NHA to meet potential claims. As in the case of other insurers, it is to be expected that the FSLIC would take measures from time to time to require insured institutions to meet certain standards as a condition to continued protection. Otherwise, excessive risks created by the improvident practices of certain institutions could jeopardize the FSLIC's ability to meet its commitments to depositors nationwide. Therefore, absent evidence that Congress intended otherwise, it appears to us that the Board's authority to issue the challenged rule is inherent in its mandate, under section 1725(a),[1] to prescribe the rules and regulations required for carrying out the purposes of the subchapter.

The Court found no credible evidence that Congress intended otherwise at and upheld the Board's direct investment regulation.

Consequently, the authority provided by section 218 of the administration's draft legislation to the FDIC to limit state-chartered activities of state-chartered thrifts could be no broader than FSLIC's regulatory authority as recognized by the Lincoln court. But for the first time, the authority would be clearly and unambiguously set forth by statute and would not be subject to the possibility of future court decisions inconsistent with Lincoln.

Section 1725(a) provides:

> There is created a Federal Savings and Loan Insurance Corporation . . . which shall insure the accounts of institutions eligible for insurance as hereinafter provided, and shall be under the direction of the Federal Home Loan Bank Board and operated by it under such bylaws, rules, and regulations as it may prescribe for carrying out the purposes of this subchapter.

In reaching its decision, the Court also relied on 12 U.S.C. § 1730(e), (m). Section 1730(e) provides:

> If, in the opinion of FSLIC, any insured institution . . . is engaging or has engaged . . . in an unsafe or unsound practice . . . or is violating or has violated . . . a law, rule, or regulation, . . . FSLIC may issue . . . an order to cease and desist from any such violation or practice.

Section 1730 (m)(3) provides:

> In the course of or in connection with any proceeding under this section, the Corporation . . . is empowered to make rules and regulations with respect to any such proceedings.

(SENATOR RIEGLE)

Question 2

Concern has been expressed that if a thrift institution were unable to meet applicable capital standards by June 1, 1991, the Administration's proposal would require that the institution be sold or liquidated.

(a) Is that true?

Answer

No. Section 314 of the proposed regulation states "that after June 1, 1991, the Chairman shall prohibit the asset growth of any savings association or class of savings associations not in compliance with capital standards established pursuant to this subsection." It does not require that institutions be sold or liquidated.

(b) What consequences would a solvent institution face if it were unable to meet applicable capital standards?

Answer

As set out above, failure to meet capital standards would result in a prohibition of asset growth. In addition, the Board could take action to require an insured institution to increase its capital to required levels. Thus, the Chairman could enter into a supervisory agreement with such institution, impose a cease-and-desist order, or issue a capital directive pursuant to 12 C.F.R. § 563.14-1 (1988) requiring the institution to achieve its minimum capital requirement by a specified date, submit and adhere to a compliance schedule and plan to achieve its requirement; and take any other action, such as reducing its assets, reducing its rate of liability growth or restricting payment of dividends, to cause the institution to reach its required capital level. In addition, under the current provisions of the administration's proposal, a solvent institution that has no tangible shareholders' equity, *e.g.*, an association whose capital consists of deferred losses and goodwill, could be subject to termination of insurance by the FDIC. Moreover, the Treasury technicals would remove the standard and substitute "tier one capital of less than one percent of risk-adjusted assets."

(SENATOR RIEGLE)

Question 3

Concern has been expressed (a) that the stronger capital standards proposed by the Administration could cause many marginally healthy thrift institutions to fail, and (b) that these additional failures would increase the cost of dealing with FSLIC's problems. What is your response?

Answer

The Administration's proposal requires that the Bank Board adopt a capital regulation that is no less stringent than that for commercial banks. In December of last year, the Bank Board proposed the most comprehensive risk-based capital regulation in existence at any regulatory agency. This proposal will address credit risk, interest-rate risk, and off-balance sheet risks. When fully implemented, the rule will require the average thrift to hold 8 percent capital against risk-weighted assets. Half of this requirement will have to be in the form of core-equity capital--common stock and retained earnings. This proposed risk-based regulation is no less stringent than the risk-based capital proposals put forth by commercial bank regulators.

We recognize that some institutions will not be able to meet these standards. Such institutions will be limited in the types of activities in which they can engage and will be required to establish a feasible plan to come into capital compliance. By placing these institutions under tight supervisory control they will be unable to take excessive risks that might otherwise result in higher cost to the FSLIC.

We have also proposed a rule that will allow the insurer to take control of an institution if its core equity capital drops below 1.5 percent of total assets. This so called "early intervention rule" will further reduce losses to the insurer.

To be effective, risk-based capital requirements must require higher capital from those institutions that pose greater risks while rewarding low-risk institutions with a lower capital requirement. Our proposed regulation meets this test.

It is important, however, that legislation not be enacted that would render our efforts ineffective. Most notably, it is critical that any overall capital-to-asset test (leverage ratio)--as opposed to a risk-based requirement--that may be established for thrifts and commercial banks be low enough not to discourage low-risk portfolios. If the minimum capital-to-asset threshold is set too high, then portfolios consisting of low-risk assets such as Treasury securities and 1- to 4-family residential mortgages may no longer be viable investment alternatives for financial institutions.

(SENATOR RIEGLE)

Question 4

Section 314 of the Administration's proposal requires the Chairman of the FHLBS to prescribe capital standards "not less stringent than the capital standards applicable to national banks." Would the capital standards that the Bank Board published in the Federal Register on December 23, 1988, pass muster under section 314?

Answer

The Bank Board's proposed risk-based capital standard would meet the test of being "not less stringent" than the risk-based standards that apply to national banks. While section 314 would require the Bank Board to make some modifications (such as in the treatment of goodwill, deferred loan losses, and certain subsidiaries), our December 1988 proposal was designed specifically to be as stringent a capital rule as the risk-based capital rule that applies to national banks.

Our proposal would not meet the section 314 test with respect to the non-risk-based capital standard (or "leverage ratio") that also applies to national banks. The current national bank "leverage ratio" requirement is 6% capital/total assets. Because thrift portfolios generally present significantly less credit risk, such a requirement, if applied to thrift institutions, would be significantly greater than the proposed risk-based capital standard, rendering the latter moot. The Bank Board's proposed risk-based capital requirement explicitly incorporates interest-rate risk, and higher capital requirements for investments that banks are not allowed to make. Since the leverage ratio is designed to capture those risks not incorporated in the risk-based rule, we believe that it is appropriate for the bank and thrift industries to have different "leverage ratio" requirements.

We understand that the Office of the Comptroller of the Currency is in the midst of discussions with the other bank regulators as to what minimum leverage ratio should be retained once they go to risk-based capital standards.

(SENATOR RIEGLE)

Question 5

Under the Administration's proposal, a thrift institution that persistently fails the qualified thrift lender test would eventually be treated as a bank. Do you support that provision?

Answer

The Qualified Thrift Lender (QTL) test was formulated in 1986 as part of the CEBA legislation. CEBA provides that any savings association that fails to maintain its QTL status* would have its access to FHLBank advances limited. Under CEBA, a failure to qualify does not eliminate an association's access to FHLBank advances, nor does it require the association to undergo a change in charter. An association that fails the test can reapply for QTL status after a five year waiting period.

As developed in the Administration's proposal, the purpose of the QTL test is decidedly different from that reflected in the CEBA legislation. The Administration's proposal requires that any savings association that fails to achieve or maintain its QTL status convert to a bank charter within three years of losing its QTL status. However, during that three year period, the association is not in any way limited in its access to FHLBank advances. Not until three years have passed are any limitations placed on the association's activities.

As outlined in CEBA, the test is more flexible and it provides an immediate response in the event of a failure to qualify: it measures an association's compliance over time, rather than at a point in time; it does not eliminate an association's access to FHLBank services, but immediately limits it to the degree the association invests in qualified thrift assets; and it provides for an association's reapplication for qualified status. As such, this view of the QTL test may be preferable.

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* QTL status is conferred on those associations that maintain 60 percent of their assets in "qualified thrift investments" for three out of every four quarters in two out of every three years.

(SENATOR RIEGLE)

Question 6

Do you believe that thrift institutions should be subject to a strong qualified thrift lender test which ensures that they center their activities on housing finance?

Answer

We believe that thrift institutions should be subject to a strong qualified thrift lender test if they are to enjoy the full range of benefits that accrue to a thrift charter. At the same time, if thrifts are to perform their traditional role of home financing, that role must be a profitable one. Assets beyond 1- to 4-family mortgages have an important role in providing profits and providing some stability to the overall earnings of the institution. As such, we think the current 60-percent level provides adequate room for diversification while ensuring continued commitment to housing finance.

I might note that as of September 30, 1988, 93 percent of solvent institutions passed the 60-percent test, but only 60 percent of them would pass the test if it were at the 80-percent level. Because of foreclosed real estate, smaller proportions of insolvent institutions pass the test.

(SENATOR RIEGLE)

Question 7

Do you believe that thrift institutions can and will continue to be viable portfolio lenders?

Answer

Thrifts remain committed to mortgages, despite their ability to lend elsewhere, because mortgage lending remains profitable. The spread between mortgage yields (including residential and commercial) and thrifts' cost of funds has generally increased since 1982, despite the presence of insolvent institutions that have added to the cost of funds for all institutions. The net margin of mortgage yields over thrifts' cost of funds since the beginning of 1984 has exceeded today's average industry operating expense ratio by an average of 45 basis points.

In addition to remaining profitable, institutions that have retained their home mortgage orientation have significantly reduced their exposure to interest-rate risk in recent years. Since 1984, 90 percent of the institutions holding over 60 percent of their assets in traditional mortgage assets have reduced their interest-rate risk exposure. And half have cut their exposure by more than 50 percent. These reductions in risk help ensure a more stable income stream for these institutions.

Finally, well-run thrifts have been generating the types of profits that attract new capital. Investors allocate capital to institutions that earn the highest after-tax, risk-adjusted return. The return on equity at GAAP-solvent thrifts generally has been higher than at banks since 1983. Thus, thrift institutions have been able to raise more than $10 billion in new equity capital, suggesting that GAAP-solvent FSLIC-insured institutions have been viable competitors in recent years with commercial banks insured by the Federal Deposit Insurance Corporation (FDIC).

The thrift industry remains a key player in residential mortgage markets. Thrift institutions hold nearly 40 percent of all residential mortgages. And in dollar terms, thrifts' total holdings of residential mortgages in September 1988 were $790 billion, nearly double from ten years ago.

(SENATOR RIEGLE)

Question 8

Why should FSLIC be separated from the Bank Board?

Answer

As I have indicated in previous testimony, there are tensions created when a single agency handles both chartering and insurance of depository institutions. This presents challenges, in the form of what I have termed "inherent conflicts of interest," but it also provides the agency with a broader set of powers than would be available if it served in only one of these roles. We have been able to use these broader powers judiciously to our advantage in our deal-making in the past. Specifically, we have been able to balance operating latitude in our operating agreements with the required outlays in our assistance agreements. Without this flexibility, many agreements may not have been possible.

I believe that the alternatives of placing chartering and insurance under a single authority or dividing these functions between agencies can both work to create feasible, effective regulatory structures. The important consideration is not whether both functions are performed by a single agency, but whether the structure of the system in place will serve the public interest. The bill under consideration separates the insurance function from the FHLBS. I am confident that the provisions of the bill are more than adequate to ensure that the resulting structure will provide a safe and sound thrift industry.

(SENATOR RIEGLE)

Question 9

You testified that the proposed FHLBS "must have the same latitude as the Office of the Comptroller of the Currency. To give it less or to leave more with the FDIC or the surviving insurance entity is to put the thrift industry . . . at a disadvantage as far as the going forward possibilities and opportunities of the industry is concerned."

(A) Why would limits on the authority or discretion of the FHLBS necessarily put the thrift industry at a disadvantage?

(B) Is there any reason to believe that the FDIC would regulate less effectively in the public interest than the Bank Board has in the past or than the FHLBS would in the future?

Answer

The asset portfolios and corresponding risks at thrifts and commercial banks remain quite different. This distinction necessitates a specialized regulator familiar with the assets and strategies of the unique institutions they regulate. It is our view that although the FDIC is well-intentioned, it may by design or default favor the banking industry over the thrift industry on particular regulatory issues. Because the FDIC is not as familiar with real estate and assets secured by real estate, its actions or inactions may put the thrift industry at a competitive disadvantage with the banking industry as well as other alternative sources of real estate and real estate related credit.

Because of the FDIC's relative unfamiliarity with the thrift industry, it would also take the FDIC longer to get up to speed. Moreover, if certain economic scenarios occur, e.g., mounting Third World debt problems or continued problems in the farming and energy sectors, more of the FDIC's resources could be required to examine and supervise commercial banks and therefore divert attention from the thrift industry.

(SENATOR RIEGLE)

Question 10

Does the Administration's proposal give the FDIC any authority over federally insured thrift institutions that FSLIC does not currently have over such institutions (apart from increases in enforcement powers)? If so, describe each respect in which the authority proposed for the FDIC exceeds FSLIC's current authority.

Answer

The following is a description of the FDIC's authority over federally insured thrift institutions that exceeds the FSLIC's present authority:

Liability of Commonly-Controlled Institutions

Section 206(5) of the FIRREA would authorize the FDIC to seek reimbursement from any other commonly-controlled insured financial institution for any loss in connection with the default of an insured financial institution, or in connection with providing assistance to an insured financial institution in danger of default. The section also provides that the FDIC must notify the commonly-controlled institution within two years of the date the FDIC incurs the loss, sets forth the methods to be used to calculate the loss incurred by the FDIC, the procedures for collecting this amount and the provisions for administrative and judicial review of the FDIC's action.

The Federal Home Loan Bank Board and FSLIC have no comparable authority.

FDIC Approval of Conversion Transactions

Section 206(5) of FIRREA also would provide that no insured financial institution may participate in a conversion transaction without the prior consent of the FDIC. The term "conversion transaction" is defined in the same section as "the change of status of an insured financial institution . . . from a Bank Insurance Fund member to a Savings Association Insurance Fund member or from a Savings Association Insurance Fund member to a Bank Insurance fund member." Under the Competitive Equality Banking Act of 1987 ("CEBA"), 12 U.S.C. §1727(c)(2), there is a two-year moratorium on institutions leaving the FSLIC insurance fund.

Before CEBA, the Board could, pursuant to 12 C.F.R. §563.22, prevent institutions from leaving FSLIC. This regulation requires Board approval of certain transfers of assets. The issue was not explicitly addressed by statute.

Assessment of Premiums

Section 208 of the FIRREA would amend section 7 of the FDIA, 12 U.S.C. §1817. Pursuant to the FIRREA provision, the FDIC would have the authority to set assessment rates for insured financial institutions annually. That authority includes the authority to fix rates above the base line rates set in the FIRREA, up to 35 basis points, so long as any year's assessments are not more than a 50 percent increase over the annual assessment rate for the prior year. The authority to charge the larger than base line assessments must be based upon at least one of the following occurrences: 1) the Savings Association Insurance Fund ("SAIF") has a net loss in any one of the prior three years; 2) SAIF reserve ratio falls below 1.20 percent; or 3) "extraordinary circumstances exist that raise a reasonable risk of serious future losses" to the SAIF. The FDIC would also be authorized to charge a minimum premium of $500, or a higher amount set by the FDIC, to cover direct expenses; that minimum amount could be collected notwithstanding the fact that it exceeds the percentage premium levied against other financial institutions--even if the actual premium exceeded the 35 basis point limitation.

Pursuant to the NHA, 12 U.S.C. §1727(b), (c), the amount of premiums charged savings institutions by the FSLIC is set by statute: a regular annual premium of one-twelfth of one percent of total deposits and a sliding scale additional premium set by Congress in CEBA. The FSLIC is currently unable to set annual assessments beyond the parameters set forth in the NHA, except for its ability to collect additional annual premiums up to one-eighth of one percent [the full additional premium prior to CEBA], notwithstanding the CEBA amounts, upon a showing of "severe pressures" on the insurance fund "which necessitate[d] an infusion of additional funds." The FSLIC is not authorized to charge a minimum premium such as the $500+ premium that the FDIC will be authorized to collect.

FDIC Authority to Disapprove Proposed Acquisitions

Section 208(7) of the FIRREA would amend section 7(j) of the FDIA, 12 U.S.C. §1817(j). Pursuant to amended section 7(j)(7)(F) the FDIC may disapprove any proposed acquisition if the appropriate Federal banking agency determines that the proposed transaction would result in an adverse effect on the Bank Insurance Fund, the Savings Association Insurance fund, or the Deposit Insurance Fund.

Section 407(q) of the NHA, 12 U.S.C. §1730(q), sets forth the factors to be considered by the FSLIC in deciding whether to approve a proposed acquisition of an insured institution. These factors include: antitrust concerns; whether the financial condition of any acquiror is such as might jeopardize the financial stability of the institution or prejudice the interests of depositors; and, whether the acquiror possesses sufficient competence, experience or integrity to control the institution.

Section 408(e)(2) of the NHA, 12 U.S.C. §1730a(e)(2), sets forth the factors to be considered by the FSLIC in granting approval to a savings and loan holding company seeking to acquire an insured institution. These factors include: the financial and managerial resources and future prospects of the company and institution involved; the convenience and needs of the community to be served; and antitrust concerns.

It is unclear whether the discretion granted to the FDIC by the FIRREA, to disapprove any proposed acquisition that would result in an adverse effect on the insurance funds, is broader than the authority exercised by the FSLIC under the sections of the NHA cited above.

Authority of FDIC to Define Terms in FDIA

Section 209(3) of the FIRREA would amend section 9 of the FDIA, 12 U.S.C. 1819, by providing the FDIC the authority to "define any terms used in the Federal Deposit Insurance Act, as amended, that are not specifically defined in the Act, and to interpret the definitions of any terms that are not so defined." This broad authority is not explicitly granted to the FSLIC with respect to its enabling statute, the NHA.

FDIC as Receiver

Section 211 of the FIRREA would amend section 11 of the FDIA, 12 U.S.C. §1821(c). Pursuant to this section, the FDIC would be authorized to accept appointment to act as receiver or conservator for financial institutions in default upon appointment by the institution's primary regulator. The institution may be placed into a receivership or conservatorship for purposes other than liquidation. If the institution is placed into a conservatorship for purposes other than liquidation at the request of the primary regulator, the FIRREA allows the FDIC to take over the assets of the institution and operate the institution with all the powers of the shareholders, directors and officers of the institution. The FDIC may also elect, however, to liquidate the receivership even though the primary regulator requested it only to place the institution into a conservatorship for purposes other than liquidation.

This authority, which allows the FDIC to liquidate a conservatorship without the approval of the primary regulator of the institution, is greater than the FSLIC's present authority. Section 401(d) of the National Housing Act, 12 U.S.C. 1724(d), defines the term "default" as "an adjudication or other official determination of a court of competent jurisdiction or other public authority pursuant to which a conservator, receiver, or other legal custodian is appointed for an insured institution for the purpose of liquidation". Accordingly, the FSLIC may liquidate an institution only if it is directed to do so by a court of competent jurisdiction or other public authority, such as the Bank Board. Pursuant to section 211(2) of FIRREA, the FDIC may elect to liquidate an institution without being directed to do so by another authority.

Section 211(3) of FIRREA may require the FDIC to obtain the approval of the primary regulator of an institution placed into conservatorship before placing the institution into a liquidating receivership. This section provides that, "in cases in which the financial institution continues to operate in conservatorship the institution shall remain subject to the supervision of its primary regulator." This section is inconsistent with section 211(2) quoted above. Although the financial institution would remain subject to the supervision of its primary regulator, the FDIC may nevertheless elect to liquidate the institution without obtaining approval from the primary regulator.

FDIC Authority to Convert Savings Associations to National Banks or to Establish Bridge Banks

Section 211(7) of the FIRREA would amend section 11(h) of the FDIA, 12 U.S.C. §1821(h), which authorizes the FDIC to liquidate an insured bank and organize a new national bank to assume the insured deposits of the closed bank. The FIRREA would amend section 11(h) by replacing the term "closed bank" with the term "financial institution in default." The effect of this amendment would be to authorize the FDIC to change the status of a financial institution from a savings association to a national bank.

Section 211(8) of the FIRREA would amend section 11(i) of the FDIA, 12 U.S.C. §1821(i), by authorizing the FDIC, in its discretion, to establish a bridge bank or banks when one or more insured financial institutions are in default or in anticipation of becoming in default. Section 11(i)(1)(C) of the FDIA, as amended by the FIRREA, would authorize the FDIC to transfer the assets, liabilities and deposits from a savings association that is in default to a bridge bank that is organized as a national bank rather than as a savings association.

By using either of these amended sections of the FDIA, the FDIC would be able to change a savings association to a national bank. The FSLIC and the FHLBB have no corresponding authority. Moreover, the authority provided by sections 211(7) and 211(8) to the FDIC may be exercised without the concurrence of the FHLBS, the primary regulator of the institutions involved.

Termination of Status as Insured Entity

Section 902 of the FIRREA would amend section 8 of the FDIA, 12 U.S.C. §1818, the provision covering the FDIC's ability to terminate the insurance for an insured financial institution. Currently, the FDIA provision is substantially similar to the analogous FSLIC provision, 12 U.S.C. §1730(b)-(d) (section 407(b)-(d) of the NHA.

However, the FIRREA amendments would provide the FDIC certain authority previously unavailable to both the FDIC and the FSLIC. These amendments would: 1) allow the FDIC to give a financial institution notice of termination proceedings if insufficient corrective action is taken within sixty days, rather than the previous 120 days; 2) allow the institution to continue operating, after termination is ordered, for "a period of at least six months or up to two years, within the discretion of the [FDIC]," rather than the previous period of two years; and 3) grant the FDIC the ability to issue a temporary order suspending deposit insurance on all deposits received by an institution after the effective date of the order when a finding is made that the institution "has no tangible shareholders' equity that qualifies as tier one capital."

(SENATOR RIEGLE)

Question 11

Given the past failures of Federal thrift regulation, could Congress and the Administration reasonably conclude that the FDIC should have greater authority over federally insured thrift institutions than it has over national and State member banks?

Answer

I do not favor giving the FDIC greater authority over thrift institutions than it has over national and state member banks.

Three of the factors that led to the current situation are on their way to a permanent remedy. These are: the maintenance of adequate levels of real capital, the replenishment of the insurance fund so that problem institutions can be closed at a much earlier stage and the total rebuilding of the Bank Board's supervisory system.

Thrift institutions are different from banks. Their assets differ in that they are usually real-estate related and often long term. Their liabilities also differ in the greater use by thrifts of long-term deposits, Federal Home Loan Bank advances, and repurchase agreements. Furthermore, thrifts often engage in portfolio strategies that, while different from banks, are entirely appropriate and beneficial when viewed in a thrift's portfolio context. Since the portfolio of a thrift is fundamentally different from that of a bank, it makes sense to leave the major part of thrift regulation with those most familiar with thrift portfolios and operating strategies.

Furthermore, in recognition of the factors that led to the current situation and in anticipation of possible future difficulties, the Bank Board has moved on a variety of fronts to improve and to enhance the quality of regulatory oversight.

To address regulatory policy weaknesses, the Bank Board adopted equity-risk investment, growth, and revised minimum capital regulations. For example, in December 1988, the Bank Board proposed extensive revisions to the minimum capital (risk-based capital) requirements so that they would more fully reflect the risks that an institution poses to the FSLIC. These proposed rules address both credit-risk and interest-rate risk. Furthermore, they capture most off-balance-sheet risks. The proposed rule closely parallels commercial banks' requirements in the area of credit risk, but goes further to address interest-rate risk, a risk we believe is too important to ignore. The bank rule does not adjust for interest-rate risk.

To head off potential future problems, we have issued a number of regulatory bulletins. For example, one establishes guidelines for the use of mortgage derivative products and mortgage swaps and limits the use of such instruments by insolvent, weakly capitalized, and otherwise troubled institutions. Another addresses thrift investment in high-yield ("junk") bonds and provides detailed guidance on appropriate underwriting standards. And yet another establishes guidelines for thrifts to use in monitoring and in controlling interest-rate risk.

As the industry was deregulated, some thrift managers undertook new activities and lines of business before they acquired the skills necessary to run such operations safely. Weak or fraudulent management, inadequate capital, and insufficient state regulatory oversight combined to create severe problems. The Bank Board's supervisory and examination staff was also not well prepared for the new activities. The Bank Board transferred the examination staff to the District Banks in July 1985 to improve both the quantity and quality of the staff. Both goals have been accomplished. In terms of quantity, the examination and supervision staff has nearly doubled since 1985. The staff has expanded from 1,063 in June 1985 to 2,153 in February 1989.

The Bank Board also has improved the training and education of examiners. To ensure that thorough, consistent, and appropriately targeted examinations are made, the Bank Board has developed specific procedures that examiners perform when evaluating a thrift institution or its subsidiaries. These procedures emphasize safety and soundness, using a "top-down" approach of evaluating management, policies, and procedures.

We have also increased the frequency of exams. Well-run institutions are examined at least every 18 months. Those with problems are examined more frequently, with a "full scope" exam at least annually. Our examinations place special emphasis on the ability of management and the prudence of activities.

Another area of increased oversight has been in the area of institutions undergoing changes of control. In the early 1980s, these changes too frequently led to major shifts in management that resulted in poor decision making. The Bank Board has not only strengthened the change-in-control regulations, but it has also improved its sharing of information with federal commercial bank regulators regarding the background of potential investors.

These actions suggest to me that the Bank Board and the FHLB System are well prepared to effectively regulate federally-insured thrift institutions.

(SENATOR RIEGLE)

Question 12

The Bank Board has often been described as having a legal duty to promote the thrift industry.

(A) Does the Bank Board have any such duty?

Answer

The Bank Board is not under "a legal duty to promote the thrift industry." Under section 5 of the Home Owners' Loan Act, the Board "in order to provide thrift institutions for the deposit or investment of funds and for the extension of credit for homes and other goods and services . . . is authorized . . . to provide for the organization, incorporation, examination, operation, and regulation" of Federal associations "giving primary consideration to the best practices of thrift institutions in the United States."

Moreover, the Federal Home Loan Bank Board and the Federal Home Loan Bank System provide thrifts with a source of funds with which to make mortgages and to act as the lender of last resort. H.R. Rep. No. 1418, 72nd Cong., 1st Sess., at 4, 9-12 (1932). This authority was created in response to indications that home ownership was declining due to "an insufficient amount of low-cost, long-term, installment mortgage money . . . . Our national credit structure needs . . . these home loan banking units to serve the small saver and the home buyer in the cities and small towns." Id. at p.9.

Although the authorized activities of thrifts have undergone substantial modification in recent years, the mission of these institutions is still the same. For instance, the preamble to the Garn-St Germain Depository Institutions Act of 1982 states that the "Act [is] to revitalize the housing industry by strengthening the financial stability of home mortgage lending institutions and ensuring the availability of home mortgage loans." Pub. L. 97-320, 1982 U.S. Code Cong. & Admin. News; id. at pp. 3067-3069. The report of the Bush Task Group also affirmed this residential housing finance purpose of thrifts. BLUEPRINT FOR REFORM: The Report of the Task Group on Regulation of Financial Services (1984), pp. 67-70 (Discusses the characteristics of thrift status, chief of which is participation in financing residential housing).

(B) Identify every provision of current law under which the Bank Board claims authority to act as an advocate for or promoter of the thrift industry.

Answer

The Bank Board does not claim such authority.

(C) Section 6 of the Home Owners' Loan Act of 1933 authorized the Bank Board to spend certain sums "to encourage local thrift and local home financing and to promote, organize, and develop" thrift institutions. Would you agree that section 6 became a dead letter once those funds were spent? If not, why not?

Answer

At the time the Home Owners' Loan Act was legislated, many areas of the United States were without thrift institutions. Congress was concerned that the residents of such areas would not be able to take full advantage of the legislation because there was no one in those counties familiar with the uses and operations of thrifts. Thus, the sum of $150,000 was appropriated in order to

> encourage and build up in these communities that have no thrift association, institutions that will encourage the home-owning and home-building idea, which is the real foundation and stability of our country.

Cong. Rec. H2579 (daily ed. April 28, 1933)(statement of Rep. Reilly). See Cong. Rec. S4974 (daily ed. June 5, 1933) (statement of Senator Bulkley).

The Bank Board believes that once the funds appropriated under section 6 were expended, the Board's legal obligation under that section was satisfied.

(D) If the Bank Board has any promotional obligations, do those obligations ever under current law take precedence over preserving the safety and soundness of FSLIC-insured institutions or protecting the FSLIC insurance fund? If so, what gives them such precedence?

Answer

The Bank Board has no such obligations.

(E) To your knowledge, has it ever been the Bank Board's policy that promotion should take precedence over preserving the safety and soundness of FSLIC-insured institutions or protecting the FSLIC insurance fund?

I am not aware whether it has been the Bank Board's policy that promotion should take precedence over the Board's statutory responsibilities. It is not and has not been the policy of this Board.

(SENATOR RIEGLE)

Question 13

If the Federal Home Loan Bank System were independent of the Treasury, what would prevent it from being overly close to the thrift industry?

Answer

The realignment of the Federal Home Loan Banks' boards of directors and the increased presence and importance of public interest directors* will go a long way toward preventing the FHLB System from becoming too close to the thrift industry. Also, requiring the principal supervisory agents, the top regulator in each district, to report directly to Washington will provide added deterrence to industry interference in the supervisory process.

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* Section 703 of FIRREA provides that three of the nine FHLBank directors will represent the industry, three will represent the public, and the remaining directors will be jointly chosen by the first six directors to represent the housing and financial services industry. In addition, the three public members will serve as Chairman, Deputy Chairman, and Second Deputy Chairman of the board.

(SENATOR RIEGLE)

Question 14

If Congress exempted the FHLBS from the Government pay scale and the budget-authorization process, what justification (if any) would there be for having thrift examiners and supervisors be employees of the industry-owned Federal Home Loan Banks?

Answer

If the whole Federal Home Loan Bank System including the FHLBB, the District Banks, and the joint offices are completely exempt from government pay scales, budget authorization, and staffing restraints, there would no longer be adequate reason to have the examination and supervisory staff as employees of the District Banks. However, the whole Federal Home Loan Bank System would need to be exempt from any legal or practical constraints on the ability to compensate employees and staff offices. It is my understanding that the Office of the Comptroller of the Currency, ("OCC") is technically legally exempt from federal pay scales. However, because the OCC is a constituent unit of the Department of Treasury and because Treasury is subject to federal pay limitations, the Treasury Department requires that OCC salaries be no higher than the federal pay cap. Thus, the OCC's legal authority to pay market rate salaries is limited by practical considerations imposed by its overseer.

(SENATOR RIEGLE)

Question 15

(A) What do you currently estimate will be the costs of FSLIC-assisted transactions that were entered into during 1988? State the key assumptions on which the estimate is based, including assumptions about future interest rates and the difference between the book and market value of assets covered by yield-maintenance and capital-loss agreements, as well as any discount rate used.

(B) Will the Bank Board promptly notify the Committee if your current estimates increase by more than $2 billion?

Answer

The estimated present value cost is $37.927 billion. The cost can be broken into three parts: $28.361 billion for assisted acquisitions, $2.586 billion for liquidations, and $6.980 for stabilizations.

The primary assumptions consist of (1) the structure of the assistance agreement, (2) the composition of the institution being acquired (amount of troubled assets and negative net worth, asset yields, etc.), (3) the expected disposition rates for the troubled assets, (4) future interest rates and (5) the discount rate.

(1) The structure of the assistance agreement comes from the bid proposal and subsequent negotiation of the agreement. There is no standard assumption because each bid is unique.

(2) Information about the thrift being acquired comes from several sources: the institution's thrift reports, audit reports, examination reports, and the FHLB supervisory staff.

(3) The policy for determining disposition rates for troubled assets changed twice in 1988. Prior to August 1988, disposition rates were related to the amount of yield maintenance coverage in the agreement. For example, troubled assets with no yield maintenance were assumed sold over two years while assets with yield maintenance were sold much more slowly. In August 1988, the disposition rates for Texas were changed to 7.5 years due to the nature of the Texas assistance agreements and the Texas economy.

In October 1988, another change was made to enhance the comparison between liquidation cost estimates and bid cost estimates. Except in cases where there was no yield maintenance or a very limited period of yield maintenance, the timing of the asset sales was related to the perceived difficulty in selling the assets. For example, troubled assets in Texas and Oklahoma thrifts were assumed sold over 7.5 years whereas assets from healthier economies were assumed sold over 4 - 5 years, depending upon the extent of asset problems in the specific institutions.

(4) The interest rate scenarios used were all moderately-rising scenarios, with sensitivity analysis available for many cases. In the moderately rising scenarios, interest rates increased about 1% to 1.5% over a 3-year period of time, and then remained flat afterwards.

(5) The discount rate policy changed in June 1988. Before then, the Treasury yield curve was used for discounting. Since then, the FICO bond rate has been used. The discount rate used for most December resolutions was 9.86%.

Immediately prior to the resolution of a case, the estimates of the present value cost of solution are prepared via modeled projections. Once the case has been officially acted upon by the Bank Board, future changes to estimated cost are made through standard accounting procedures which affect the Statement of Condition liability account: Allowance for Loss-assistance agreements. The Committee is notified of these changes when FSLIC's Statement of Condition and Income are distributed each year to Congress.

(SENATOR RIEGLE)

Question 16

Is there currently any reason to believe that any thrift institutions whose insolvencies were resolved in 1987 or 1988 will need another resolution? If so, how many institutions are in such danger?

Answer

There is no reason to believe at this time that thrift institutions resolved in 1987 or 1988 will require another resolution. Before completing transactions, the FSLIC conducts viability analysis on the resolved institutions. Only if this analysis indicates that the resultant institution is viable is the transaction completed.

(SENATOR RIEGLE)

Question 17

Under section 408(m)(1)(A)(i) of the National Housing Act, FSLIC may currently authorize any company to acquire a failed or failing FSLIC-insured thrift institution "notwithstanding any provision of the laws or constitution of any State" or (with a few exceptions) "any provision of Federal law." The Administration's proposal would transfer section 408(m) to the Federal Deposit Insurance Act, and generally transfer to the FDIC the powers heretofore exercised by FSLIC. However, the FDIC would be required to "obtain the prior concurrence of . . . the Chairman of the Federal Home Loan Bank System in connection with the override of any provisions of the laws or constitution of any State or any provision of Federal law." Why should such concurrence be required?

Answer

Section 408(m) provided the FSLIC with expanded powers to assist troubled thrift institutions by permitting assistance when severe financial conditions exist, and by increasing the forms of assistance. This section allowed the FSLIC to authorize an insured institution eligible for FSLIC assistance to enter into a merger, conservatorship, transfer of assets and liabilities, or acquisition with any other insured institution, FDIC-insured bank, or company, and enabled the FSLIC to arrange transactions across state lines notwithstanding other restrictions on interstate acquisitions.

Section 214(8) of the Administration's proposal would require that acquisitions authorized by section 13(k) of the FDIA and which involve the override of State or Federal law must receive the prior concurrence of the Chairman of the FHLBS. This requirement is necessary because of the broad regulatory authority granted to the Chairman of the FHLBS over savings associations by the Administration's proposal in sections 302, 305, and 702, among others. These provisions would provide the Chairman of the FHLBS with broad authority to issue regulations for the safe and sound operation of savings associations, to encourage savings associations to maintain their role of providing credit for housing, and to carry out the responsibilities of the FHLBS.

Accordingly, the Chairman is authorized to, among other things, prescribe uniform accounting and disclosure standards, to establish capital standards, equity risk investment limitations, and appraisal and asset classification policies for all savings associations. The Board also remains, pursuant to section 319 of the proposal, the primary supervisory and regulatory authority for the interpretation and administration of the Savings and Loan Holding Company Act (12 U.S.C. § 1730a).

Consequently, the regulatory and supervisory functions over savings associations remain with the Chairman of the FHLBS. The Chairman would have the most detailed knowledge of the effect upon a savings association of a transaction under section 408(m) and of the waiver of statutes and regulations, including statutes governing the FHLBS and regulations promulgated by the FHLBS. Thus, the provision requiring the prior concurrence of the Chairman with regard to the override of laws in connection with an emergency thrift acquisition is appropriate and should be retained.

(SENATOR RIEGLE)

Question 18

We have heard some States have done a poor job of preventing unscrupulous or otherwise unqualified persons from obtaining control of federally insured banks and thrift institutions -- and then engaging in fraud or other insider abuse that has been costly for the deposit insurance funds?

(A) What is your response?

(B) Do you believe that the Federal change-in-control statutes need to be strengthened?

Answer

Fraud and insider abuse have been perpetuated in certain state-chartered thrift institutions under the control of individuals who, upon closer scrutiny, should not have obtained approval to enter the industry. The Board has already taken steps to prevent future problems stemming from changes-in-control. In the early 1980s, changes-in-control too frequently led to major shifts in management that resulted in poor decision making. In response, the Bank Board has not only strengthened the change-in-control regulation, but it has also improved its sharing of information with federal commercial bank regulators regarding the background of potential investors.

In addition to the steps already taken, the Board has recommended stronger legislation providing additional bases for denial of change-in-control applications. The Administration's bill provides three key amendments to the federal banking agencies' removal and prohibition authority. The first would provide an industry-wide bar for individuals removed from any financial institution. This means that individuals would no longer be able to move freely from banks to thrifts to credit unions once barred from any one segment of the financial services industry. Second, the proposal will clarify that agencies do not lose jurisdiction over an individual merely because the officer or director resigns his office. Third, the Administration proposal will standardize the grounds for removal and prohibition among all the federal financial regulatory agencies regardless of whether the offensive conduct was perpetrated by an officer, a director or a person participating in the affairs of the financial institution and regardless of whether the misconduct occurred at the institution where the individual is presently employed or at another institution that had previously employed the individual. I discuss these amendments at greater length in my answer to question 19.

(SENATOR RIEGLE)

Question 19

The enforcement provisions of the Administration's proposal have been criticized as "overkill" and "unnecessary." What is your response? Why are those provisions justified?

Answer

The Board supports the Administration bill and we particularly support the enforcement provisions. The Board has been seeking enforcement enhancement legislation for five years with little success. Last year, we joined forces with all the federal banking regulators to submit proposed legislation that was introduced in the Senate as Senate Bill 1886. The regulators' bill, as it was known, did pass the Senate, but failed to make it out of committee in the House and died with the end of the last Congress. The House introduced a different bill, H.R. 3929, that contained many of the same concepts as the Senate-passed legislation, but it also failed to obtain committee approval and also died. The House proposal has been reintroduced this year as H.R. 32. The Administration proposal includes the enforcement enhancements contained in the regulators' bill plus an increase in the breadth and amount of civil money penalty authority and a number of new authorities for the Department of Justice.

We are heartened by the increased funding provided the Department of Justice for pursuing crimes against financial institutions. We support and urge Congress to provide Justice with at least the full proposed amount. Successful prosecution of white-collar crime in the savings and loan industry involves presentation of paper-intensive cases that require time and expertise to prepare. More U.S. attorneys and investigators are needed in several areas of the country in order to handle the volume of referrals in the savings and loan industry alone. Justice has been responsive within its limited resources, but more people and funds are needed. The "Texcon" and "Thriftcon" Task Forces demonstrate what can be done when criminal investigators and prosecutors are able to concentrate on financial institution crime. I believe that the funding now being discussed would enable the Justice Department to achieve similar results in many more areas of the country.

The proposal enhances the cease-and-desist authority of all the federal banking regulators in several areas. First, the existing statutes are clarified to expressly empower the agencies to require as part of a cease-and-desist order: "reimbursement, restitution, indemnification, rescission, the disposal of loans or assets, prohibitions or restrictions on growth of the institution, guarantees against loss, or other appropriate action. This express statutory grant is in direct response to the decision of Larimore v. Conover, 789 F.2d 1244 (7th Cir. 1986), which questioned the OCC's authority to order a director of a national bank to make restitution for losses suffered as a result of violations of lending limitations. The proposal also clarifies that the Federal Home Loan Bank System (which under the Administration proposal would replace the current Bank Board) will have cease-and-desist authority with respect to all service corporations and all subsidiaries of service corporations whether wholly or partly owned. If the Board had had this authority previously, the Board could have halted the activities of certain state-wide service corporations including one that was responsible for originating and selling to many savings and loans throughout the country bad real estate loans that ultimately resulted in substantial costs to the parent savings institutions and to the FSLIC.

Additionally, the proposal would grant the banking agencies the authority to issue a temporary cease-and-desist order if the books and records of the institution are so incomplete or in such disarray that the financial condition of the institution cannot be determined. This grant would eliminate the need of the agencies to determine the amount of the loss before obtaining the order. This will allow immediate action to gain control over the operations of such institutions and prevent further losses in the process.

There are three key amendments to the federal banking agencies' removal and prohibition authority in the proposed Administration bill. The first would provide an industry-wide bar for individuals removed from any financial institution. This means that individuals would no longer be able to move freely from banks to thrifts to credit unions once barred from any one segment of the financial services industry. It is an unfortunate drain on resources to require the other regulators to pursue their own removal and prohibition orders against an individual who has already been removed and prohibited by another regulator. An industry-wide bar makes both common and regulatory sense and we urge its adoption.

Secondly, the proposal will clarify that agencies do not lose jurisdiction over an individual merely because the officer or director resigns his office. This will make explicit the current interpretation of the statutes followed by all the federal banking regulatory agencies and several courts, e.g., Anaya v. FHLBB, 893 F.2d 1349 (9th Cir. 1988). However that interpretation was very recently called into doubt by the U.S. Court of Appeals for the District of Columbia in Stoddard v. Board of Governors, decided March 8, 1989. The Stoddard decision finds that one may escape the jurisdiction of the three federal banking agencies (not the Bank Board) by resigning before being served with removal papers. The proposed legislation will "correct" this untenable result.

And third, the Administration proposal will standardize the grounds for removal and prohibition among all the federal financial regulatory agencies regardless of whether the offensive conduct was perpetrated by an officer, a director or a person participating in the affairs of the financial institution and regardless of whether the misconduct occurred at the institution where the individual is presently employed or at another institution that had previously employed the individual. We strongly support these amendments and urge their adoption.

Another beneficial provision of the Administration proposal is the expansion of civil money penalty authority for all the federal banking regulatory agencies. The Bank Board, unlike other banking regulators, presently has such authority only in very isolated circumstances. The amendments expand the applicability of civil money penalties to violations of any law or regulation relating to financial institutions, or any condition imposed in writing by the appropriate federal banking regulatory agency in connection with the grant of any application or other request by an insured financial institution, or for the breach of any fiduciary duty or engaging in any unsafe or unsound practice where the breach or practice results in loss to the institution or gain to the individual. The proposal also includes civil money penalty authority for violations of reporting requirements and call reports.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRANSTON
FROM M. DANNY WALL

(CRANSTON)

Question 1

Isn't it true that in the early mid-1980's, the FSLIC used goodwill as a primary incentive, tantamount to assistance, to boost the capital of institutions acquiring failed or failing thrifts thereby avoiding a payout from the FSLIC fund?

Answer

In the early 1980's, the Bank Board removed regulatory restrictions that had precluded the application of GAAP regarding the amortization of goodwill. While the previous Bank Board restriction had required goodwill to be amortized over a 10 year period, GAAP allowed amortization of goodwill over its useful life--not to exceed forty years.

Prior to this regulatory change, most mergers were accounted for using the "pooling" rather than the "purchase" method of accounting. The pooling method sums the balance sheets of the merging thrifts. Assets, liabilities, and equity of each entity continue to be recorded at historical cost. Thus, in mergers using this accounting method, no goodwill is created.

Under the purchase accounting method, assets and liabilities of the acquired thrift are recorded at fair value and its existing net worth eliminated. Typically, in an acquisition, goodwill resulted because the fair value of liabilities assumed exceeded the fair value of tangible assets acquired. The difference is an intangible asset, usually called goodwill.

This method of accounting was typically advantageous to the acquirer because earnings (in accordance with GAAP) were enhanced in the years immediately following the acquisition. This occurred because discounts established when loans having below market contractual rates were marked-to-market were accredited or added to income over approximately a ten year period on an accelerated basis. Simultaneously, the corresponding goodwill was amortized or expensed on a straight line basis over a significantly longer period of between 25 and 40 years. This timing difference enhanced the income stream equity of the resulting thrift. This use of GAAP accounting thereby created an incentive to acquire thrifts.

GAAP was changed in 1983 with the issuance of SFAS No. 72. This statement eliminated the income enhancement resulting from both the accelerated accreditation of discounts and the extended amortization period for goodwill that had typically resulted from the application of purchase accounting.

The Bank Board sometimes further enhanced the accounting incentives of purchase accounting by permitting the inclusion of FSLIC assistance to an acquirer in its net worth. GAAP would have reflected this assistance by reducing goodwill by the amount of such assistance. Additionally, after the issuance of SFAS No. 72, the Bank Board continued to accept an amortization period for goodwill exceeding GAAP standards.

(SENATOR CRANSTON)

Question 2

In light of these earlier FSLIC practices, to what extent would the exclusion of goodwill from capital affect savings institutions? For example, how many institutions would fail the tangible capital standard under the proposed legislation; and second, how many institutions would be unable to meet their regulatory capital requirements under the proposed legislation allowing all goodwill to be amortized over a maximum 10-year period?

Answer

In general, the treatment of goodwill does not affect many institutions, although some that are affected are quite large. Of the 2585 GAAP-solvent institutions in existence on December 31, 1988, 1930 had no goodwill. However, of the GAAP-solvent institutions, 136 are tangible insolvent.

Section 314 of the proposed legislation requires that capital standards not less stringent than those applicable to national banks be applied to thrift institutions. In addition, the proposed legislation requires for the amortization of goodwill over 10 years. Our preliminary analysis of this requirement suggests that, at the close of the 10-year period, 500 of the currently GAAP-solvent institutions would not be able to meet this requirement if the goodwill amortization rules are not changed. If they are changed, 536 will not be able to meet the requirement by 1998.

(SENATOR CRANSTON)

Question 3

To what extent have the costs of rendering insolvent, institutions carrying goodwill on their books been considered in calculating the costs of the proposed legislation? What would the cost of such actions be to FSLIC (or the proposed SAIF)?

Answer

As noted in the answer to question 2, there are 136 GAAP-solvent institutions that are tangible insolvent. These institutions have negative tangible net worth of $4.2 billion. However, approximately half of these institutions were profitable in 1988. While I am not certain how the Administration included these institutions in their cost analysis, it seems unlikely that many of these institutions will require assistance in the future.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD
FROM M. DANNY WALL

(SENATOR DODD)

Question 1

Chairman Wall, I know that you and the Board have already taken some steps to increase the capital requirements for thrifts.

As you know, much concern has been raised by the Committee over the timetable envisioned by the Administration's plan. We understand that institutions that don't meet the 1991 deadline won't be closed down, but will be prohibited from growing until their capital levels meet the 6% requirement.

Still, it is my understanding that there are a great many thrifts with capital well below the 6% level.

Given this, do you think the two-year timetable is too demanding?

Answer

As of December 1988, there were 1723 thrifts with GAAP net worth less than 6% of assets. These institutions held $1 trillion in assets, however, 1226 of these institutions with assets of $640 billion had net worth between 3 and 6% of assets. It is inappropriate, however, to focus on a 6% capital/total assets standard. The bank regulators have recently adopted an 8% capital to risk-weighted assets standard (based on the international Basel Accord). Banks will be required to meet this new risk-based capital standard after December 31, 1990. The Bank Board's recently issued proposed rule to revise the capital standards applicable to thrift institutions also relies on a risk-based standard, and also aims for an 8% capital to risk-weighted assets requirement.

In general, I believe that a risk-based capital standard is a better measure of capital adequacy, particularly when interest-rate risk is explicitly incorporated in the formula. It is important that the legislation distinguish between a risk-based capital standard and a "flat" (or a non-risk-adjusted) capital requirement. While the standards imposed by the bank regulators' risk-based capital requirements are realistic for thrifts (including a two-year timetable), a 6% "flat" leverage ratio that my be appropriate for banks is not appropriate for thrifts, due to the differences in bank and thrift portfolios and the fact that the Bank Board's rule will explicitly incorporate interest-rate risk. Due to the underlying risk attendant to their respective portfolios -- thrifts traditionally have a much greater preponderance of home mortgage loans, which generally have very low credit risk. A "flat" rule based on the banking standard would penalize these types of portfolios.

(SENATOR DODD)

Question 2

Yesterday, the Comptroller of the Currency, Mr. Clarke, discussed his view of the need for maintaining his office's regulatory powers over banks. He indicated that, while the bank insurer seeks to protect the integrity of the insurance fund, the regulator has an important role in assuring the continued viability of the industry, and the services it supplies to the Nation.

Could you comment on this view, as applied to the thrift industry?

How should regulatory and enforcement powers be apportioned between the FDIC and reconstituted Bank Board?

Answer

I fully concur with the Comptroller's view that the regulator has an important role to play separate and apart from the insurer. The regulator has the bird's-eye view of the industry and can serve to foster the efficiency and effectiveness of the industry through authorization of new services and products.

It is our view that the reconstituted Bank Board must be preserved as the primary regulator of the thrift industry. It must therefore have full regulatory, examination, supervision and enforcement power over the industry. However, we recognize the need of the FDIC, assuming it will be the insurer of the deposits held by savings and loans, to have access to information that will enable it to assess the risk to it as insurer and to commence termination of insurance proceedings when it concludes, pursuant to statutory procedures, that continuation of insurance poses too high a risk or would otherwise be inappropriate under statutory standards.

Consistent with our role as primary regulator, the bill could be improved in several ways. Among these are revision of Section 902(2) regarding termination of insurance. As drafted, that provision preserves the right of the OCC and Federal Reserve Board, with respect to institutions for which they are the primary regulator, to receive notice of the practices or violations which may lead to a termination of insurance proceeding, to be followed by a period in which corrective action may be taken. The Federal Home Loan Bank System has not yet been given that same right except with respect to federal savings banks, a small part of the total number of institutions for which it is the primary regulator.

We believe that the bill would better preserve the distinction between primary regulator and insurer if it were revised to give us the right to notice and a corrective period for all savings associations, thus paralleling the provisions governing the same relationship between the FDIC and the other federal banking regulators.

In Section 902(18) of the bill, the FDIC is given the right, after conducting its own examination of a thrift, to request that the FHLBS take a specified enforcement action. If the FHLBS either fails to do so or to submit a satisfactory plan for dealing with the problem at hand, the bill permits the FDIC to take such action on its own. We believe it is entirely appropriate for the FDIC, as insurer of all accounts, to be watchful of undue risks to its fund, but the action reserved to it in such cases should be limited to termination of insurance and ought not to include the other range of supervisory and enforcement actions that should be employed by the primary regulator.

(SENATOR DODD)

Question 3

The House Government Affairs Committee and the GAO have cited abuses in the real estate appraisal business as a significant contributor to the crisis. I am considering legislation to clean up this business along the lines offered by Congressman Barnard.

What is your evaluation of the role played by the inflated real estate valuations?

Do you have any recommendations for changes to put an end to these abuses?

Answer

Faulty and fraudulent appraisals, whether resulting from the negligence and/or the fraud of the appraiser or the failure of the savings and loan institution to assure that the appraisal submitted in support of a transaction meets regulatory requirements, have been a significant contributing factor to the crisis in the industry. The Board aggressively pursues recoveries for losses to which faulty and fraudulent appraisals have contributed and applauds Congressman Barnard's work in this area.

Pursuant to section 402(a) of the Competitive Equality Banking Act, the Board adopted a new appraisal regulation, promulgated on January 7, 1988.

The appraisal rule places responsibility upon management to develop, implement and maintain appraisal practices and procedures in accordance with the Board's regulation. There are three standards in the rule that must be included in each institution's appraisal policies: (1) appraisals must be based on market value as defined in the rule, (2) appraisals must be completed in a narrative format (unless specifically exempted, and (3) appraisals must contain a sales history of the real estate appraised. In addition, management is to develop and adopt guidelines pertaining to the hiring of appraisers and must annually review the performance of all appraisers used within the preceding 12-month period.

The Board believes that adherence to these three standards as well as careful appraiser hiring and work review procedures provide a solid basis for safe and sound appraisal practices. Specific suggested components of an appraisal policy are provided in the Board's policy statement which institutions may adopt as their own.

Regardless of the standards imposed by the Board, there remains the potential for fraud and abuse. To alleviate, if not eliminate this problem, the Board reiterates its support for the "Depository Institutions Insider Abuse Prevention and Enhanced Enforcement Powers Act" that was introduced by Congressman Barnard in 1988 as H.R. 3929. The Board specifically supports section 108 and 109 which contain provisions that would directly authorize the Board to take disciplinary action against appraisers who produce faulty or fraudulent appraisals or directors, officers, or individuals acting on behalf of an insured institution who attempt to influence the outcome of an appraisal.

Licensing and certification of appraisers at the state level can ensure a degree of competence but cannot prevent individuals from engaging in fraudulent schemes. H.R. 3929 would represent an important step in the effort to deter fraud where most appraisal-related losses can be traced.

(SENATOR DODD)

Question 4

Chairman Wall, as you know, the bill under consideration would increase the insurance premiums for both FDIC and FSLIC institutions.

For FDIC member banks, premiums would be increased to 12 basis points in 1990, and to 15 basis points in 1991. The level would continue until the FDIC fund reaches its target reserve level of 1.25% of deposits. How long will that take?

The plan also calls for boosting FSLIC insurance premiums from the present 20.8 basis points, to 23 basis points starting in 1991. The premium rate will move back down to 18 basis points in 1994, and presumably will stay there until such time as the new FSLIC fund meets its target reserve level. How long will that take? Won't this arrangement burden thrifts with a competitive disadvantage for some time to come?

Another point on the question of increased premiums. What about the plan's assumption that thrift deposits will grow at 7% annually?

It is my understanding that the industry actually lost deposits last year. Do you have any reassuring information on this point?

Answer

The Bank Board has made no estimates on the length of time it will take each of the insurance funds to reach their respective target levels. We have, however, given consideration to the differential insurance premiums that the proposal anticipates.

The 3 basis point differential between the cost of deposit insurance for SAIF members and for BIF members reflects differences in the cost of providing such coverage. Historic comparisons of loss rates by the FSLIC and the FDIC indicate that, even in usual times, FSLIC losses have been a bit higher than FDIC losses. If SAIF losses exceed BIF losses, a differential would continue, as it should. However, if SAIF losses are less than BIF losses, SAIF premiums can decline below the level of BIF premiums.

To fully evaluate the possible effect of differential costs between banks and thrifts, all elements of cost must be included. Although, at least initially, SAIF insurance will cost more than BIF insurance, there are other cost elements that differentiate membership in the two funds. First, capital requirements will differ between the funds. For example, the risk-based capital requirement recently proposed by the Bank Board accounts for interest-rate risk; whereas there is not yet an interest-rate risk component in the requirement for banks. A conservatively-run thrift institution that has very little exposure to interest rate fluctuations would benefit under the Bank Board's proposed rule. This benefit could easily reduce costs by more than the 3 basis point differential between SAIF and BIF insurance.

Second, another element of costs for banks and thrifts is the loss reserve deduction on corporate income taxes for which SAIF members would remain eligible. This deduction provides a cost advantage for SAIF members that offsets the extra cost of SAIF insurance. For example, considering both the differential costs of SAIF insurance and the loss reserve deduction, a thrift with a return on assets of 80 basis points would have a cost disadvantage of less than 1 basis point.

The assumption in the Administration plan of a 7 percent annual growth rate in total deposits is based on past experience. The plan uses this assumption to estimate the resources available to the new insurance fund over the next ten years. It is important to stress that 7 percent is a long run average that approximates average annual growth over the type of longer planning horizon for which it is used in the plan. In any shorter period there may be deviations from the long run trend. However, for the purposes to which the plan puts this assumption, it is necessary to take a long term perspective rather than base forecasts on transitory deviations from long run trends.

Although there were net deposit outflows of $8.6 billion at FSLIC-insured thrifts in 1988, total deposits, including interest credited, grew by approximately $40 billion, a growth rate of 4.2 percent. In more recent months, there have been significant deposit outflows. There are several reasons for the recent activity. First, the difference between interest rates on thrift accounts and rates available on assets that compete with them, such as money market funds, has widened, leading some to switch from thrift deposits to competing assets. Second, some of the recent declines have been the result of Bank Board policy of shrinking the size of insolvent institutions. Third, recent news reports may have created uncertainty among depositors.

We believe that all three of the above factors will abate in the near future. Since interest rates at thrifts usually lag other rates, the yield differentials between thrift deposits and money market funds will probably decline. As insolvent institutions are resolved, the effect of policy-induced shrinkage at operating insolvents will disappear. Finally, the passage of legislation that resolves the FSLIC problem will have the additional benefit of fostering confidence among depositors.

(SENATOR DODD)

Question 5

As you know, I sent you a letter asking whether an infusion of a limited amount -- perhaps $2 billion -- would be cost-beneficial during the interval before final legislation is developed. That letter was overtaken by events -- the Treasury plan.

Now, however, it still appears that it will take us a few months to legislate. Would a limited amount of cash be useful? Where could we get it from? How could it be used?

Answer

Additional funds, if provided by Congress, could result in significant cost savings to the Federal Savings and Loan Insurance Corporation ("FSLIC").

Currently, FSLIC's funds come from four sources: the regular annual insurance premiums; the special assessment of one-eighth of one percent of total deposits per annum; the proceeds from the sale of FICO obligations; and the cash returned to FSLIC from the sale of receivership assets. At the present time, any additional funds would need to be appropriated by Congress. An immediate infusion of cash, an expansion of FICO borrowing authority, or removal of annual borrowing restrictions would be used to liquidate institutions, purchase assets and assist in acquisitions.

In a liquidation, cash is required to either pay off insured depositors or to pay another institution for the insured deposits transferred. The initial cash outlay equals the total insured deposits less any discount if the deposits are sold and transferred. Subsequent to the payment of deposits, the FSLIC as receiver recovers cash from the sale of assets of the failed institution. The recovery process takes 3 to 7 years depending on the characteristics of the institution's assets and economic factors. When calculating the liquidation cost, the FSLIC computes the immediate cash outlay and reduces that amount by the present value of the anticipated recoveries of FSLIC as receiver. Hence, any cash infusion to spend on liquidations would quickly be utilized.

The purchase of high book/low net realizable value (NRV) assets covered by assistance agreements would effectively eliminate the yield maintenance paid by the FSLIC. These payments are based upon the book value, so the greater the difference between book and NRV, the smaller the chance for recovery of the asset at a rate fast enough to offset the yield payments. Given the availability of funds, the FSLIC would purchase those assets which provided the greatest benefits to the FSLIC, tax and other factors considered and/or buy back or pay down FSLIC notes where the yield is highest.

Additional funding could also be used to fund assisted acquisitions. The availability of cash for assisted acquisitions would attract more acquirers and therefore increase the competition for a successful resolution.

Clearly, FSLIC could utilize a cash infusion in a manner which would result in a significant cost savings.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GRAHAM FROM M. DANNY WALL

(SENATOR GRAHAM)

Question 1

Mr. Wall, when you appeared before the Committee in May, I asked you whether you thought there was a conflict of interest between the two hats you wore of Chairman of the FHLBB and the FSLIC. You responded to me that there "was a place and a purpose to be accomplished by "tensions created by the "inherent conflicts of interest." You also said "But it (tensions) is clearly there and it gives us additional tools, it gives us additional flexibility, and I think it is as well, a reflection on how the Congress has historically as I said earlier, of continued to support the thrift industry vis-a-vis the savings and the residential lending aspect of the industry."

You also followed up in writing to former Chairman Proxmire and my question by saying: "We believe that this approach is preferable to the separation of these functions. The specialized nature of the thrift industry requires that the insurance function be closely tailored to the industry by regulators with a deep understanding of its needs. Moreover, the competing interests that sometimes arise can, in fact, operate as checks on both the regulatory/supervisory function as well as the insurance function."

Mr. Wall, what are your comments now to separating FSLIC from the FHLBB?

Answer

As my earlier answer indicated, there are tensions created when a single agency handles both chartering and insurance of depository institutions. This presents challenges, in the form of what I termed "inherent conflicts of interest," but it also provides the agency with a broader set of powers than would be available if it served in only one of these roles. We have been able to use these broader powers judiciously to our advantage in our deal-making in the past. Specifically, we have been able to balance operating latitude in our operating agreements with the required outlays in our assistance agreements. Without this flexability, many agreements may not have been possible.

I believe that the alternatives of placing chartering and insurance under a single authority or dividing these functions between agencies can both work to create feasible, effective regulatory structures. The important consideration is not whether both functions are performed by a single agency, but whether the structure of the system in place will serve the public interest. The bill under consideration separates the insurance function from the FHLBS. I am confident that the provisions of the bill are more than adequate to ensure that the resulting structure will provide a safe and sound thrift industry.

(SENATOR GRAHAM)

Question 2

In Florida a new S&L was reopened after one of the December deals with the Bank Board. This reconstituted S&L has started offering high interest rates because this new institution needs liquidity and has driven up the rates of the rest of the institutions in the area.

The increased rates are making it harder for the banks and the healthy S&L's to do business in that area.

My impression Mr. Wall was that by doing these deals rates would come down. Rates are going up because of this deal? What went wrong? Or what should the FHLBB be doing?

Answer

In December 1988, Golden West (the holding company of World Savings) signed a three year option agreement with FSLIC to acquire Beach. This acquisition is pending until certain provisions have been confirmed. In the meantime, Golden West is managing the institution. Beach is now considered a healthy institution and Golden West is managing Beach without restrictions.

During the fourth quarter of 1988, Beach increased total assets by $140 million (49.1% annualized rate). Liability growth was limited to $13 million while total deposits decreased $20 million. Essentially all asset growth was attributable to the increase in capital brought about by the issuance of $38 million in subordinated debt to Golden West for cash and the issuance of additional FSLIC notes.

Interest rates offered on deposits by Beach have increased significantly since December 31, 1988. Current rates offered by Beach are substantially higher than average Florida rates quoted by Bank Rate Monitor (March 6, 1989).

It appears that the institution has increased interest rates on deposits to stem the deposit outflows which have totaled $50 million for the last three months ending January 31, 1989. Beach has experienced a liquidity problem due to the deposit outflows and other cash needs.

It is important to note that Beach did not utilize this strategy to generate growth. This strategy was primarily implemented to counter deposit outflows and to preserve the franchise value of Beach.

To control the high interest rates paid by weak or insolvent institutions, in September 1988, the Bank Board issued Regulatory Bulletin 3A (Policy Statement on Growth for Insured Institutions) which significantly restricts growth at undercapitalized institutions. In addition, the Bank Board has implemented the "As Agent" program to provide institutions with an alternative to the direct retail deposit market and has encouraged FHLBanks to take a more active role in providing advances as an alternative source of funds.

(SENATOR GRAHAM)

Question 3

Yesterday in Mr. Seidman's testimony he said "Since this is a complex determination, appropriate flexibility should be provided the insurer so that the proper time-frame and balance can be assured." (in S&Ls meeting the capital standards.)

Some of the larger S&Ls who have done deals with the Bank Board since 1982 believe they cannot meet the capital targets and particularly the 10 year phase-in of goodwill still will not help them. They have large goodwill amounts because of their taking over weaker S&Ls who also had large amounts of goodwill.

Do you think these S&Ls in general can meet the capital requirements by 1991?

Should special consideration be given to institutions that took sick S&Ls at the request of the Bank Board and acquired a lot of goodwill?

Answer

Many of the thrift institutions that took over "sick" thrifts will not be able to meet the new capital requirements by 1991, in part due to the amount of goodwill on their books (assuming that they must either eliminate or rapidly amortize their goodwill). I believe that it is appropriate to review the specifics of each institution on a case-by-case basis to determine if progress is being made (or is likely to be made) toward meeting the capital requirement. If such progress is being made, then we should exercise tight regulatory oversight of their activities and require them to follow capital restoration plans. If progress is not made, then the Bank Board should take appropriate action to resolve such cases. It is important that whatever decision is made that such a decision not go back on commitments that were made at the time of acquisition.

(SENATOR GRAHAM)

Question 4

What can be done to keep the marginal S&Ls from sliding into the black hold of insolvency? What are you currently doing?

Answer

While it is difficult to prevent a marginal thrift from becoming insolvent, the Bank Board does take numerous actions to prevent these institutions from imposing costs on the FSLIC. For example, once an institution fails its minimum capital requirement, it is placed under more thorough supervisory control. Many of our regulations are specifically tied to compliance with capital requirements. Likewise, growth by undercapitalized institutions is constrained. Undercapitalized institutions are also subjected to more frequent examinations and more continuous monitoring by supervisory personnel. Finally, undercapitalized institutions are required to submit capital restoration plans, identifying what strategies they will undertake to return to capital compliance.

(SENATOR GRAHAM)

Question 5

Some persons have criticized the 100th Congress for not acting in 1988 to provide FSLIC with additional money.

A. When the Competitive Equality Banking Act of 1987 was enacted, did you believe that the Act's $10.825 recapitalization of FSLIC would be sufficient for FSLIC's 1988 and 1989 needs? If not, identify each occasion (if any) on which you informed Congress that the recapitalization would not meet those needs.

B. Did the Federal Home Loan Bank Board, at any time after July 1987, inform the 100th Congress that FSLIC lacked resources sufficient to carry out its responsibilities? If so, identify each occasion on which the Bank Board so informed Congress (stating the date, means, recipient, and substance of the communication).

Answer

As I outlined in my March 1, 1989 testimony, there is a history of difficulties in assessing the magnitude of the problem. Even before I came to the Bank Board, considerable disagreement existed about the funds needed as the Congress considered the Recapitalization Plan for the FSLIC. In 1986, the Senate and the House each passed $15 billion recapitalization bills that went unreconciled. In 1987, the Reagan Administration proposed a $15 billion plan, whereas the industry argued that only $5 billion was needed. Considerable differences of opinion also were evident that year in Congress. Although the Senate's recapitalization bill in 1987 provided for $7.5 billion in borrowing authority for the FSLIC, two earlier attempts to expand this authority had been defeated in the Senate Banking Committee. The House, during the same session, passed a $5 billion package after several attempts to raise the borrowing authority were defeated. House supporters of the $5 billion plan argued that the Congress would have to revisit the issue in two years anyway, since no one knew exactly how much would be needed.

The conference committee agreed on a bill that included $8.5 billion, despite reported general agreement that this amount would be insufficient. The White House announced that it would veto the conference bill because President Reagan wanted greater FSLIC borrowing authority. Treasury Secretary Baker intervened, and a compromise bill was passed by the Congress providing $10.825 billion, but which limited borrowings to $3.75 billion per year.

In previous testimony, I also discussed the evolution of the Bank Board's own cost estimates. The early 1988 estimate of $22.7 billion for the cost of resolving troubled thrifts represented our best effort based upon generally accepted accounting principles using data thru September 30, 1987. The estimate included costs for resolving all institutions in the FSLIC caseload, those in the Southwest Plan, and all other GAAP-insolvent institutions, the largest portion of which was concurred in by the GAO, our auditors. Our year-end 1987 estimate, which I reported to the Senate Banking Committee in May of 1988, suggested that the special assessment on thrifts would have to be continued for almost eight years in order to meet our obligations.

In July 1988, the FSLIC issued detailed cash flow projections for the next 10 years based upon estimates of future resources and case-resolution costs. As for the earlier and subsequent estimates, the need to continue the special assessment years into the future formed the basis for these cash flow projections because it was the only way the FSLIC could effectively obtain additional revenues, despite the Competitive Equality Banking Act's (CEBA) provision for a potential phase-out of this assessment. Specifically, at that date, we concluded that the special assessment would have to be extended to at least ten years. During the preparation of these cash flows, which we presented to the House Banking Committee in July 1988, we were able to analyze fourth-quarter 1987 financial data reported by individual thrifts and the actual resolution costs of early Southwest Plan cases. Based upon this new information, we reassessed the estimates made a few months earlier that had relied on September 1987 data. The newly available data showed a sharper-than-expected pattern of asset write-downs in the southwest and, thus, a need to raise our cost estimate, as well as to extend the special assessment. Accordingly, we included an additional $8.2 billion for the Southwest Plan and revised our total cost estimate upward to $30.9 billion.

In October of 1988, the FSLIC once again updated its estimate based on information from a large number of additional resolution actions and from the June 30, 1988 financial data. The revised estimate suggested that the cost for the resolution of future FSLIC cases would range from $24.9 billion to $29.9 billion. To these figures was added the estimated $20 billion in FSLIC notes and guarantees under assistance agreements for those cases that had already been resolved. This yielded a present-value estimate ranging between $45 billion and $50 billion. It should be noted that, in the presentation to the Senate Budget Committee in October of 1988, we once again extended the length of time--to 30 years--over which we believed the special assessment would have to be levied to meet our new and higher estimate, and further questioned how feasible it would be to do so.

In my March 8, 1989 testimony before the Subcommittee on VA, HUD and Independent Agencies of the Committee on Appropriation of the House of Representatives I stated the following:

To develop such an estimate, all institutions that, as of December 31, 1988, might impose costs upon the FSLIC were identified. Thus, solvent but thinly capitalized institutions were included in this broader estimate.

Based on this group of institutions and financial data available through September 1988, the Bank Board estimates that as of December 31, 1988, the cost for resolving troubled thrifts is between $75 billion and $80 billion. Included are $38 billion for cases not yet resolved (see Table 1) and $38 billion for cases acted upon during calendar year 1988.

Based on our experience, it cannot be emphasized strongly enough how important prompt additional funding is to prevent further escalation in resolution costs.

The following statements from my previous testimonies further suggest that recapitalization was inadequate and that FSLIC lacked resources to complete its task.

o "The ultimate decision by Congress was to go with a piece of the solution, approximately $11 billion--$10.825 billion--and the Congress and the next President be able to assess how far we will have been able to work through the problem with those resources." (April 27, 1988, House Banking Committee, page 41.)

o "...FSLIC possesses adequate resources in the near term (emphasis added) to deal effectively with the immediate problems... The Bank Board cannot guarantee (emphasis added) that Congress will not be called upon in the future to provide additional funding to FSLIC." (July 7, 1988, House Banking Committee, page 20.)

o In reviewing FSLIC resources, the Bank Board "presumes that we extend the special assessment over a very extended period of time." (October 5, 1988, Senate Budget Committee, page 47.)

Table 1
Estimated Cost as of December 1988 for Resolving Remaining Troubled Thrifts
(Based on September 1988 Data)

Status of Institutions	Number	Assets ($ Billions)	Net Worth ($ Billions)	Estimated Resolution Cost ($ Billions)
GAAP Insolvent*				
FSLIC Cases	109	23.0	-5.0	7.3
Southwest Plan Cases	69	26.5	-5.7	12.8
Other	85	28.6	-1.5	3.9
No Cost Expected	68	16.0	-0.5	0.0
GAAP Solvent—Troubled				
Non-Southwest	70	91.8	-1.3	9.1
Southwest Plan Cases	54	17.7	-.1	4.9
No Cost Expected	123	66.7	-0.3	0.0
Total	578	207.3	-14.4	38.0

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* Institutions that were identified GAAP insolvent as of September 30, 1988. During the Fourth Quarter of 1988, additional institutions listed as GAAP solvent but troubled may have also moved into this category.

(SENATOR GRAHAM)

C. Did the Bank Board, at any time after July 1987, ask the 100th Congress to provide FSLIC with additional money (other than by giving it carte blanche to issue Government-guaranteed promissory notes)? If so, identify each occasion on which the Bank Board made such a request.

Answer

While never specifically requesting additional money from Congress, the above referenced statements certainly implied that additional resources would be necessary to fully meet future FSLIC obligations.

D. In requesting Congress to guarantee nondeposit obligations incurred by FSLIC (e.g., FSLIC notes), did the Bank Board offer to accept any limit on how much of such obligations could be outstanding at any one time? If so, when was the offer made, to whom was it made, and what limit was proposed?

Answer

We requested a full faith and credit resolution for all FSLIC obligations to eliminate the negative accounting disclosures that precluded many companies from acquiring troubled thrifts. To the best of my recollection, no limit on this guarantee was ever publically offered by the Bank Board.

During the late summer of 1988 in discussions with the leadership of the House and Senate Banking and Appropriations Committees and staff of the Committees, the idea of a limit was discussed several times and at different amounts, ranging from $11 to $28 billion. The consideration peaked and ended when first the Senate amendment to pledge full faith and credit was passed by the Senate then removed on the House side as part of the appropriation bill. It again was raised as the Senate Banking Committee was preparing a counter package in anticipation of the so called LaFalce Bill passing the House. The LaFalce Bill failed to receive a "rule" from the House Rules Committee and thus, it died.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN
FROM M. DANNY WALL

60

(SENATOR GARN)

Question 1

Under the Administration legislative proposal, what exactly is the capital standard that thrifts must satisfy by the 1991 deadline? Is it a flat 6 percent of assets? Is it the risk-adjusted ratio of 7.25 percent, which later goes up to 8 percent? Is it the higher of these two standards? There is significant confusion about this important question that needs to be cleared up.

Answer

Under Section 314 of the Administration's proposal, by no later than June 1, 1991, thrift institutions must be subject to "capital standards" that are "no less stringent" than those established for national banks. The bill does not specifically refer to either the minimum capital regulations currently in effect for national banks, located at 12 CFR 3.6, which require national banks to "have and maintain total capital equal to at least 6 percent of adjusted total assets and primary capital equal to at least 5 1/2 percent of adjusted total assets," or to the recently adopted risk-based capital guidelines that will be contained in 12 CFR Part 3 Appendix A. Those guidelines contain a transition period beginning on December 31, 1990 and ending on December 30, 1992. According to the OCC, on December 31, 1990, "banks will be required to meet an interim minimum total risk-based capital ratio of 7.25%." 54 FR 4169 (January 27, 1989). (The ratio will be 8% after December 31, 1992.) That ratio is calculated upon an institution's risk-based, rather than total, assets.

The OCC has stated that after December 31, 1990, by which time it anticipates that it will have proposed and adopted certain amendments to 12 CFR Part 3, "banks will be required to maintain a minimum capital ratio computed as a percentage of total assets, in addition to complying with the provisions of the risk-based capital guidelines." 54 FR 4170 (emphasis added). The OCC anticipates that the amendments to be proposed may lower the current 5 1/2 to 6 percent of total assets leverage ratio.

Under the Administration bill, it appears that the Federal Home Loan Bank System's capital standards for thrifts must be no less stringent than either of these national bank capital standards, in their entirety, at whatever levels are in effect on June 1, 1991. It would therefore appear that thrift capital standards would be required to contain, and thrifts to meet, both elements.

The Board would concur with the OCC, however, in the opinion that an institution's "capital requirements should be related to the riskiness of its assets and off-balance sheet activities and, therefore, that the risk-based standard should be the primary focus in determining the adequacy of [an institution's] capital." 54 FR 4170.

(SENATOR GARN)

Question 2

The Administration's plan calls for case resolution of $10 billion in the remainder of FY 1989, $25 billion in FY 1990, and $17 billion in FY 1991. Half of these case resolutions are projected to be liquidations. Is this enough of an up-front infusion of money to resolve the insolvencies you already know about? The proposed sums are obviously already large, but could the insurer profitably spend even larger sums in the first year or so to get this problem behind us? I realize that assisted mergers take time to put together and drain human resources; there obviously is a cap on the number of these that can be done in any one fiscal year. But it seems to me that liquidations or depositor payouts could be done much more quickly once you have identified the institutions that require this treatment. Isn't it just a matter of writing checks to depositors or transferring deposits to nearby institutions, which can be done relatively quickly? Furthermore, I would think that given the lack of cash available over the last several years, FSLIC must have focused its attention on the institutions that were capable of assisted mergers, which require less cash, while the proportion of liquidation candidates left in the unresolved case pool presumably went up. In short, if liquidations are cash intensive, if there are a large number of liquidation candidates already identified, and if liquidations are relatively quicker to accomplish in terms of the up-front cash payout; does the Administration's plan include adequate up-front cash in the first three years?

Answer

You are correct that liquidations require significantly more up-front cash than assisted mergers. It is difficult however to comment on whether the Administration's plan has adequate funds for liquidations. While the FSLIC did supply certain financial information to the Treasury and OMB, how the data were incorporated into the Administration's plan was their determination. Furthermore, since liquidations tend to be more costly than assisted mergers, I am reluctant to advocate widespread liquidations even if more up-front cash is provided.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ
FROM M. DANNY WALL

(SENATOR HEINZ)

Question 1

If I remember my history correctly, the savings and loan crisis started when thrifts were caught in an interest rate squeeze because they borrowed money in the form of short-term deposits and loaned money for the long-term in the form of fixed-rate mortgages. In your testimony at page 13, you acknowledge that the thrift industry remains somewhat vulnerable to increased interest rates.

However, the focus of the President's proposal, as well as others, is that a thrift industry is warranted only if it operates as a specialized housing lender and maintains a high percentage of assets in mortgage-related loans.

Isn't the thrift industry's highly concentrated portfolio of mortgages how this whole problem started?

Answer

It was not mortgage lending per se that created the problem in the thrift industry in the early 1980s but the mismatch in maturities between the mortgage instruments and deposits that funded these mortgages. In the early 1980s, thrifts were highly exposed to changes in interest rates. Most of their assets were in long-term fixed-rate mortgages while their deposits were relatively short term. The average one-year maturity gap in 1984--that is, the dollar value of assets repricing in one year minus the dollar value of liabilities repricing in one year divided by total assets--was negative 40 percent. By 1988, this figure had dropped to negative 17 percent. Thus, while a 100 basis point rise in interest rates would have reduced industry profitability by 40 basis points in 1984, it would result in only a 17 basis point decline today.

This reduction in interest-rate risk exposure has come in part through the widespread use of adjustable rate mortgages. Today, 60 percent of thrift mortgages are adjustable. Thus, thrifts remain committed to mortgage lending yet have reduced the interest-rate risk that contributed to the disaster of the early 1980s.

Thrifts have also reduced their exposure to interest rate changes by making limited use of the expanded asset powers granted by the Garn-St Germain Act. Without this ability to diversify, thrifts could be seriously exposed to the adverse effects of volatile interest rates.

(SENATOR HEINZ)

Question 2

Would you recommend that Congress increase the QTL test above the current level of 60% mortgage-related assets? If not, why not? What level would you consider most appropriate, and why?

Answer

We believe that thrift institutions should be subject to a strong qualified thrift lender test if they are to enjoy the full range of benefits that accrue to a thrift charter. At the same time, if thrifts are to perform their traditional role of home financing, that role must be a profitable one. Assets beyond 1- to 4-family mortgages have an important role in providing profits and providing some stability to the overall earnings of the institution. As such, we think the current 60-percent level provides adequate room for diversification while ensuring continued commitment to housing finance.

I might note that as of September 30, 1988, 93 percent of solvent institutions passed the 60-percent test, but only 60 percent of them would pass the test if it were at the 80-percent level. Because of foreclosed real estate, smaller proportions of insolvent institutions pass the test.

(SENATOR HEINZ)

Question 3

Which provisions of the President's proposal, if any, expressly address the thrift industry's vulnerability to holding fixed-rate mortgages?

Answer

While I am not aware of any specific provisions in the Administration's proposal that expressly address the thrift industry's vulnerability to holding fixed-rate mortgages, provisions in the Bank Board's proposed capital regulation do address these risks. Specifically, one component of the proposed capital regulation requires institutions to hold capital equal to 50 percent of the change in the market value of the institution that would result from a 200 basis point change in interest rates. Institutions holding fixed-rate mortgages that remain exposed to interest rate changes will be required to hold significantly more capital than institutions not exposed to such risks.

(SENATOR HEINZ)

Question 4

Your testimony at page 13 suggests that there are methods available to monitor and limit interest-rate risk? What are these methods? How effective are they? What more, if anything, can be done to reduce the industry's interest-rate risks?

Answer

The Bank Board currently requires all institutions to report detailed information on the maturities and interest rates on all financial assets and liabilities. With this information, we are able to fairly accurately quantify each institution's exposure to interest rate changes. Furthermore, as noted in our response to question 3, the Bank Board's proposed risk-based capital regulation will require institutions to hold capital against their interest-rate risk exposure. This will provide strong economic incentives for institutions to monitor and limit such risk.

The Bank Board also recently issued guidelines for thrift institutions to follow in monitoring and controlling their interest-rate risk. These guidelines require a thrift's Board of Directors to establish limits on such risks tied to the institution's income and capital.

Questions for The Record from Senator Donald W. Riegle, Jr.
Hearing of March 2, 1989

Riegle Question 1:

You testified that you are not certain that on-budget financing would prove cheaper than off-budget REFCORP financing because the Treasury would probably use 6-year debt which has a higher yield than 30-year debt. Presumably the Treasury could use 30-year debt. If they actually chose shorter maturities, couldn't we assume that such a choice was made because the Treasury believed it would have other benefits and therefore save even more money in the long-run?

Answer:

It is true that Treasury must balance a number of considerations in determining what mix of maturities it should use to manage Federal borrowing and the refinancing of the Federal debt. The Administration's S&L plan, however, proposes to use a unique combination of industry and Treasury funds. Borrowing $50 billion over the next three years and locking in defeasance of this borrowing are key justifications for obtaining an industry contribution to the plan. Hence, our point about the relative costs of short and long term borrowing in an inverted yield curve environment remains valid: if Treasury were to do the borrowing as part of an on-budget FSLIC rescue plan, it would have to meld an additional $50 billion in Federal borrowing into its current debt management activity. Given the way the REFCORP proposal is structured, on the other hand, its longer term borrowing may indeed not be any more expensive than Treasury financing at the present time.

Riegle Question 2:

You testified that there ought to be some cap on the obligation authority of the various insurance entities to resolve new cases. The language in the Administration's proposed legislation (Section 211 at p. 48) appears open to an interpretation that funding for additional SAIF needs to maintain adequate net worth are automatic. Is it the intent of the bill that unanticipated future spending needs should require further, nonmandatory, appropriations? If so, can you recommend how such a cap should be inserted?

Answer:

- The Treasury Department recently forwarded to Congress technical amendments to the Administration's bill to ensure that the SAIF fund will be built up as proposed, while allowing for the President and the Congress to reexamine the whole situation should the amounts authorized be inadequate.
- OMB estimates anticipate that the new SAIF will receive a total of $33 billion in funding from premium income and Treasury payments. SAIF is estimated to spend a maximum of $24 billion in resolving new cases. The technical amendment would limit SAIF obligations to this $24 billion.
- The Administration will likely request annual appropriations of a current, indefinite nature for these Treasury payments to SAIF. We would consider these appropriations to be mandatory and have proposed an exemption from Gramm-Rudman-Hollings for the SAIF account.

Riegle Question 3:

Your response was confusing on the question of whether the $40 billion estimate of the cost, in this and future fiscal years, of cases already handled includes prospective tax losses associated with those cases. Could you clarify this? How much have you allowed in the current budget and in projections of tax receipts in future years for the tax concessions made in calendar 1988 as part of assisted mergers? Are you anticipating any further tax concessions as part of future merger arrangements?

Answer:

- The $52 billion FSLIC gross disbursement figure and the $39.9 billion net budget outlay estimate are exclusive of the revenue losses (tax expenditures) to the Treasury.
- However, tax expenditures associated with FDIC and FSLIC assistance were reflected in the January budget. Revenue losses due to FSLIC assistance total approximately $8 billion from 1988-1993 for past and future cases. These estimates, however, were developed by Treasury for OMB prior to knowledge about the magnitude of the December cases and their tax effects.
- The Bank Board estimates multi-year tax losses from 1988 closures will total more than $8 billion in cash ($5.8 billion present value). The Joint Tax Committee's estimate is $7.2 billion present value.
- OMB relies on Treasury for estimates of these tax expenditures. We do not have new estimates of the tax losses for new cases, but these will be substantially less than the tax losses for 1988 cases.
  - The 1988 technical corrections to the tax reform act of 1986 cut the value of these benefits to the acquirer for cases resolved after 1988 approximately in half.
- The Administration's estimates assume the tax benefits will expire at the end of calendar year 1989, as current law provides and no further tax concessions are assumed. The Administration does not favor extension of these benefits beyond 1989.

Riegle Question 4:

> The economic conditions consistent with your interest rate and deposit growth assumptions have implications for the deposits to GNP ratios of both banks and thrifts. Declining interest rates suggest a slowing of nominal GNP, but you assume deposits continue to grow at a fairly rapid 7 percent rate. Please state how you expect nominal GNP to grow between now and 1999. What will be the ratio of deposits to GNP each year through 1999? How do the projected ratios compare to historical experience in the U.S.?

Answer:

- Administration projections show an average annual growth rate of 6.1% for nominal GNP between 1989 and 1994. Administration estimates for nominal GNP do not extend beyond 1994.
- The average ratio of bank deposits to nominal GNP is 41.6 percent over this time period. The average ratio of thrift deposits to nominal GNP is 20.2 percent over the same period.
- These figures compare to averages of 44.6 percent for bank deposits and 19.9 percent for thrift deposits over the 1980-1988 time frame.

Comparison of Nominal GNP and Deposits
($ in billions)

Forecast Levels

	Nominal GNP	Bank Deposits to Nominal GNP Ratio	Thrift Deposits to Nominal GNP Ratio
1994	6,887.5	42.5%	20.8%
1993	6,555.1	42.1	20.4
1992	6,208.5	41.7	20.1
1991	5,847.6	41.1	20.0
1990	5,475.7	41.2	19.9
1989	5,119.7	41.0	19.8

Average growth rate for 1989 to 1994 = 6.1%

Historical Levels

	Nominal GNP	Bank Deposits	Ratio	Thrift Deposits	Ratio
1988	4,861.8	2,110.2	43.0%	971.5	20.0%
1987	4,526.7	1,993.3	44.0	932.7	21.0
1986	4,240.3	1,969.7	46.0	890.7	21.0
1985	3,998.1	1,795.9	45.0	843.9	21.0
1984	3,765.0	1,645.2	44.0	784.7	21.0
1983	3,405.0	1,533.9	45.0	671.1	20.0
1982	3,073.0	1,405.2	46.0	560.5	18.0
1981	2,954.1	1,276.5	43.0	519.9	18.0
1980	2,631.7	1,192.2	45.0	503.2	19.0

Riegle Question 5:

Chairman Wall told us that most FSLIC notes and virtually all yield maintenance and capital loss agreements can be refinanced. Most of these notes and agreements are tax-exempt and involve interest costs to the FSLIC well above what the Treasury or REFCORP would pay. Yet, it appears that the Administration's plan makes no provision for using our options to refinance these obligations. Are there clear reasons why we should not try to refinance them, and, if not, what source of funding would be available? Would such funding require additional appropriations?

Answer:

The Administration's budget estimates for the S&L funding plan do not assume that existing obligations will be restructured. However, the proposed legislation calls for the new Resolution Trust Corporation (RTC) to review existing agreements to determine whether restructuring will yield a lower net cost to the Government. Cost considerations should include tax expenditures, contingent liabilities, and the time value of money.

Should it be advantageous to the Government to restructure some existing agreements, the funding sources available would be the same as are now earmarked for payments on these resolutions:

- proceeds from remaining Financing Corporation (FICO) bond issuances;
- premium income not dedicated to FICO, REFCORP, or the new Savings Association Insurance Fund (SAIF);
- proceeds from the sale of assets in receiverships already established;
- miscellaneous receipts available to the FSLIC; and
- Government (Treasury) financing to cover any shortfall.

In addition, REFCORP proceeds might be used if the RTC Oversight Board so determines. The timing of any required appropriations will change to the extent that more funds are required sooner under the restructurings. Still, we would expect that the restructured deals would result in lower costs to the Government, both in present value terms and in multi-year budget outlays.

Questions for The Record from Senator William V. Roth
Hearing of March 2, 1989

Roth Question 1:

In the March 1st Wall Street Journal, Martin Feldstein wrote an essay arguing that FSLIC funding belongs off-budget. He concludes by saying:

> "The best way to avoid establishing a precedent for uncontrolled deficit spending would be to drop the proposed Resolution Financing Corporation from the Administration's plan and have the Treasury borrow the $50 billion directly. This borrowing would properly be recorded in the budget, but would be kept out of the Gramm-Rudman calculations on the correct grounds that the rescue plan would neither increase aggregate spending nor crowd out any private borrowing. It is critically important to emphasize this reason for keeping the borrowing out of Gramm-Rudman rather than to suggest that borrowing can be disregarded whenever the government arranges to have that borrowing done by a new special-purpose corporation."

Would you comment on this? Do you accept Mr. Feldstein's argument that recognizing the FSLIC loss on budget would not have any inflationary impact? Do you agree, as Mr. Feldstein implies you do, that borrowing can be disregarded whenever the government arranges it be done by a new special purpose corporation?

Answer:

- The Administration agrees that resolution of the FSLIC crisis should not have an inflationary or contractionary impact on the economy. Quick action on the plan will likely produce positive economic effects, including lower interest rates.

- The Administration's approach is structured to assure private funding for a large portion of the package:

  - private funds (Home Loan Banks' retained earnings) are used together with industry insurance premiums to defease (guarantee) the principal on the bonds; and

  - Home Loan Banks' retained earnings and returns on sales of assets (receivership proceeds) are used to help pay interest on the bonds, with Treasury making up the shortfall.

- Financial resources (Treasury appropriations) provided by the Federal Government are kept on budget to assure full and separate accountability for use of taxpayer and industry funds.

- The use of REFCORP does not represent a new precedent for GRH budget discipline evasion. This transaction cannot be easily replicated. An entity such as the Federal Home Loan Bank System must supply the initial funding.

Roth Question 2:

Do I assume correctly, looking at Attachment C, that the S&L insurance premiums paid under the plan will pay $3.3 billion toward the $6 billion needed to buy $50 billion in zero-coupon bonds and thereafter be dedicated to building the new Savings Association Insurance Fund? While I understand that money is fungible, does this mean that the S&L premiums are insufficient to build SAIF to $24 billion by 1999 as well as to meet the $40 billion already obligated? Or any of the interest costs?

Answer:

- Under the Administration's plan, thrifts' premium income is dedicated to several uses: (1) payment of Financing Corporation (FICO) interest, (2) rebates for the now-defunct secondary reserve, (3) the defeasance of the REFCORP bond principal, (4) through 1991, payment of outstanding FSLIC obligations, and (5) after 1991, payment on any new losses on the SAIF and capitalization of that fund.

  (1) Premium income will pay the estimated annual $1.0 billion in FICO interest through bond maturity.

  (2) From 1989-1993, credits against premiums, totalling approximately $700 million, will be issued to those thrifts that had contributed to FSLIC's now extinct secondary reserve.

  (3) A total of $3.3 billion of premium income will be used to purchase zero coupon bonds in 1990 and 1991, which will defease the principal of REFCORP obligations.

  (4) Through 1991, remaining available premiums will be used to help cover the costs of FSLIC cases already resolved. A combination of premium income, FICO proceeds, receivership proceeds from "old cases", and appropriations will be used to meet the $40 billion in existing FSLIC obligations.

  (5) From 1992-1999, premium income will be used to gradually build up the new SAIF fund to a balance of almost $9 billion by the end of that period. The $24 billion in estimated 1992-1999 case spending will be financed by a combination of remaining premium income and appropriations.

- Federal Home Loan Bank earnings and Treasury payments will cover the interest costs of REFCORP obligations. OMB estimates do not assume any premium income being used to fund REFCORP interest obligations.

Roth Question 3:

In Attachment D, under Cash Outflows, there is a line for "post- RTC cases" that yields a $24 billion outflow. Is this a proper cost to attribute to "the problem"? It seems to me that there will inevitably be failures in the years ahead. I assume you included this line to give a complete picture of the next 10 years. Is the net cost to government of "the problem" too high by $24 billion? Or is that figure included in the cost since premium collections will be used to defray expenses of the resolutions rather than to meet the future contingency of past RTC cases?

Answer:

- The $50 billion provided to the Resolution Trust Corporation (RTC) should resolve the current problem: the approximately 500 institutions which either currently have negative GAAP net worth or are still solvent according to GAAP but have negative tangible net worth.
- The $24 billion estimate for "post-RTC" case expenses from 1991-99 (plus a build-up of SAIF reserves by another $9 billion over this period) should more than cover potential future insurance losses arising from any future failures. Once the current problem is resolved, average yearly insurance expenses of almost $3 billion implied by the $24 billion estimate would be very high by historical standards.
- The 1989-99 estimate of the cost to the Government (budget net outlays) for the Administration's funding and reform proposal -- $39.9 billion -- includes the estimate of $24 billion in potential post-RTC expenses, as well as the premium income that would partially offset the budget impact of these expenses and build up the new SAIF reserves.

Roth Question 4:

In Attachment F, how did you estimate receivership proceeds? You also indicate in footnote 2 that you assumed no returns from warrants or other equity interests. Do you believe that the Treasury will, in fact, receive nothing? If not, what is your best estimate?

Answer:

- Administration estimates assume 40 percent of the proceeds spent on new liquidations will be recovered, 10 percent in each of the four years following liquidation.
- The Administration's budget and cash flow projections do not assume any returns on warrants or other equity positions taken by RTC. The returns on warrants or other forms of equity participation are very difficult to predict since they depend on so many factors specific to individual merger arrangements. Therefore, in order to be conservative, the potential returns are not factored into the estimate.

Roth Question 5:

Does the Administration harbor constitutional or philosophical doubts about maintaining the Federal Home Loan Bank Board as an independent agency? Do you feel such independence violates the concept of the unitary Presidency?

Answer:

- The Administration's plan separates the chartering and supervision functions from the insurance functions, specifically by removing the FSLIC from the Bank Board's control.

- The Administration's plan places the Federal Home Loan Bank System under the general oversight of Treasury for two basic reasons:

  -- The thrift crisis highlights the necessity of strengthening the accountability of the regulator and the oversight of the regulator to Congress and the Executive branch.

  -- The proposed separation between chartering and insuring functions is parallel to the way banks are treated now: FDIC insures, OCC and States charter and regulate.

Roth Question 6:

On March 3, 1989, James Blum, the Acting Director of CBO testified that the actual "uses of cash" for the FSLIC problem between 1989-1999 amounts to $205 billion, of which $84 billion is to be raised by Treasury borrowing. Do you agree with these figures?

Answer:

- The CBO figures of $84B and $205B are based on the Administration's estimates and assumptions, but result from a different presentation of various components of the Administration plan.

- Our estimate of a $40B cost to the government and the CBO's estimate of $84B mean different things: ours is a budget cost estimate, while CBO refers to its estimate as a Treasury borrowing requirement. CBO does not refer to the $84B as an outlay estimate.

- The $84B estimate may be derived from the $40B outlay estimate by:

  (1) adding $20B for additional FDIC premiums that will not be used for thrift cases;

  (2) adding another $9 billion for the repayment of FSLIC notes issued and scored prior to FY 1989; and

  (3) adding CBO's estimate of Treasury debt service costs ($16B) associated with the plan, based on Administration assumptions.

- The Administration's estimates account for these financial flows. The $20B and $9B estimates have been identified in various tables provided to the Congress. The Treasury debt service costs are included in a separate section of the budget on debt service costs -- as is the practice for every other Federal program.

- The $205B estimate cited by CBO adds together the gross cash flows for program (case resolution) and administrative spending, repayment of FSLIC notes, interest on REFCORP and FICO bonds, and associated Treasury debt service costs. It does not account for private funding to offset case resolution or financing costs (e.g., premiums, proceeds from the sale of assets, etc.).

  -- The meaning of a figure that adds together program (e.g., case resolution) expenditures and the associated financing costs is unclear. (If a house is purchased for $100,000, one does not add $300,000 of interest payments for 30 years and say that the total cost of the house is $400,000.)

Additional Question for the Record from Senator Larry Pressler

Pressler Question 1:

Your attention is drawn to the Wall Street Journal article entitled "Bush S&L Bailout Creates Illusion of Deficit Cut That Congress Questions but Wants to Believe", which appeared in the February 22nd issue. The article discusses the Bush Administration's plan for resolving the thrift crisis, introduced as S. 413, the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA).

As the article notes, the Bush plan reduces total FY 1990 budget outlays for FSLIC and FDIC below both the 1989 and the 1990 outlay estimates for FSLIC and FDIC in the Reagan Budget. This reduction occurs even though FSLIC's total FY 1990 spending of $31.2 billion to resolve insolvent thrifts is $3.5 billion higher than total FY 1989 spending and $22.1 billion above the estimated total FSLIC spending in the FY 1990 Reagan budget. Please explain this seemingly anomalous outcome.

Answer:

The principal reason for this budgetary effect is that the FIRREA also proposes new budget receipts to help finance these increased spending requirements. The sources of these new budget receipts are:

- payments from a newly created, off-budget government sponsored enterprise -- the Resolution Funding Corporation (REFCORP) -- a subsidiary of the privately owned Federal Home Loan Banks. These REFCORP receipts fully offset increased FSLIC spending from FY 1989 to FY 1991; and

- proposed higher insurance premiums on commercial banks beginning in FY 90 -- these additional receipts offset higher FSLIC spending even though they are not directly used to finance that spending.

The article implies that REFCORP proceeds should not be considered offsetting collections to the RTC. The Administration disagrees with this view.

- According to a key principle established by the 1967 President's Commission on Budget Concepts, REFCORP should not count as government debt because the government has no ownership interest in REFCORP.

- Neither FSLIC nor the RTC have a responsibility to return REFCORP bond proceeds to REFCORP. REFCORP bond principal is guaranteed by the S&L industry through defeasance.

- However, Treasury will provide any shortfall in REFCORP interest not covered by FHLB future income or other industry payments.

- Industry resources -- including retained earnings, proceeds from the sale of assets of liquidated S&Ls and deposit premiums, supply a significant portion of the funding made available in the reform package.

- Treasury payments for REFCORP, as well as additional Treasury appropriations for the Savings Association Insurance Fund and the FSLIC Resolution Fund, are kept on-budget to assure full and separate accountability for the use of taxpayer and industry funds.

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